Supreme Court, U.S.
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In the

**Supreme Court of the United States**

JOHN DUFFIE,
and MELISSA DUFFIE,

*Petitioners*,

v.

UNITED STATES OF AMERICA,

*Respondent*.

ON A PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

# PETITION FOR A WRIT OF CERTIORARI

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## QUESTIONS PRESENTED

1. Whether 26 U.S.C. §7422(h), which bars claims for refund "attributable to" partnership items, denies the United States Court of Claims jurisdiction over partner-level refund suits for recovery of interest assessed at the 26 U.S.C. §6621(c) penalty rate, which is an affected item?

2. Is a determination of "lack of economic substance" automatically the same as a determination of "sham" where no business purpose or profit motive determination has been made, especially for purposes of imposing a penalty that uniquely requires a sham determination?

3. Is the limited 6-month statute of limitations under 26 U.S.C. §6230(c)(1)(A)(i) for filing a refund claim on the grounds that "the Secretary erroneously computed any computational adjustment necessary . . . to make the partnership items on the partner's return consistent with the treatment of the partnership items on the partner's return" applicable to a claim as described in Question 1?

## PARTIES TO THE PROCEEDINGS BELOW

The following were parties to the proceedings below before the United States Federal District Court for the Southern District of Texas and the Fifth Circuit Court of Appeals:

John C. Duffie,

Melissa Duffie, and

the United States of America.

## TABLE OF CONTENTS

QUESTIONS PRESENTED . . . . . i

PARTIES TO THE PROCEEDINGS BELOW . . . . . ii

TABLE OF CONTENTS . . . . . iii

TABLE OF AUTHORITIES . . . . . v

PETITION FOR A WRIT OF CERTIORARI . . . . . 1

OPINIONS BELOW . . . . . 1

JURISDICTION . . . . . 1

STATUTES AND REGULATIONS INVOLVED . . . . . 2

STATEMENT OF THE CASE . . . . . 2

1. Section 6621(c) Overview . . . . . 6

2. Overview of TEFRA Jurisdiction . . . . 7

a. Partnership Item Jurisdiction . . . . 9

b. Nonpartnership Item and Affected Item Jurisdiction . . . . . 11

3. History of This Case . . . . . 13

4. Facts . . . . . 16

REASONS TO GRANT THE PETITION . 18

1. Section 7422(h) Does Not Bar Affected Item Claims . . . . . 21

2. Lack of Economic Substance and Sham are Distinct Tax Doctrines . . 29

3. The Six Month Limitations Period Was Misapplied . . . . . 45

CONCLUSION . . . . . 52

## TABLE OF AUTHORITIES

### Cases

*ACM Partnership v. C.I.R.*,
157 F.3d 231 (3d Cir. 1998) . . . . . 33, 35

*Affiliated Equip. Leasing II v. C.I.R.*,
97 T.C. 575 (1991) . . . . . 22

*Alexander v. U.S.*,
44 F.3d 328 (5th Cir. 1995) . . . . . 37

*ASA Investerings P'ship v. C.I.R.*,
201 F.3d 505 (D.C. Cir. 2000) . . . . . 35

*Bail Bonds by Marvin Nelson,Inc. v. C.I.R.*,
820 F.2d 1543 (9th Cir. 1987) . . . . . 35

*Barlow v. C.I.R.*,
301 F.3d 714 (6th Cir. 2002) . . . . . 27

*Bartimmo v. U.S.*,
525 F.Supp.2d 879 (S.D.Tex. 2007) . . . 27

*Battelstein v. C.I.R.*,
631 F.2d 1182 (5th Cir. 1980) . . 38, 40, 45

*Black & Decker Corp. v. U.S.*,
436 F.3d 431 (4th Cir. 2006) . . . . . 35

*Brookstone Corp. v. U.S.*,
1994 WL 621576 (S.D.Tex. 1994)
(unpublished), aff'd without
written opinion,
58 F.3d 637 (5th Cir. 1995) . . . . . 46, 47

*Bush v. U.S.*,
599 F.3d 1352 (Fed.Cir. 2010) . . . . . 50

*Callaway v. C.I.R.*,
231 F.3d 106 Cir. 2000) . . . . . 9, 10, 12

*Casebeer v. C.I.R.*,
909 F.2d 1360 (9th Cir. 1990) . . . . . 33

*Cemco Investors, L.L.C. v. U.S.*,
515 F.3d 749 (7th Cir. 2007),
*cert. denied*, 129 S.Ct. 131 (2008) . . . . . 20

*Chamberlain v. U.S.*,
66 F.3d 729 (5th Cir. 1995) . . . . . 42, 43

*Coltec Ind., Inc. v. U.S.*,
454 F.3d 1340 (Fed.Cir.2006),
*cert. denied*,
127 S.Ct. 1261 (2006) . . . . . 20, 32, 35

*Comdisco v. U.S.*,
756 F.2d 569 (7th Cir. 1985) . . . . . 35

*Compaq Computer Corp. v. C.I.R.*,
277 F.3d 778 (5th Cir. 2001) . . . 33, 35, 36

*Conway v. U.S.*,
50 Fed.Cl. 273 2001) . . . . . 8

*Copeland v. C.I.R.*,
290 F.3d 326
(5th Cir. 2002) . . . . . 7, 26, 39, 40, 48

*Curr-Spec Partners, L.P. v. C.I.R.*,
579 F.3d 391 (5th Cir. 2009),
*cert. denied*, — U.S. —,
130 S.Ct. 3321, — L.Ed.2d — (2010). . . 19

*DeMartino v. C.I.R.*,
T.C.Memo. 1986-263,
1986 WL 22000 (1986) . . . . . 44, 45

*Dewees v. C.I.R.*,
870 F.2d 21 (1st Cir. 1989) . . . . . 34

*Dow Chem. Co. v. U.S.*,
435 F.3d 594 (6th Cir. 2006),
*cert. denied*,
127 S.Ct. 1251 (2006) . . . . . 20, 32, 35

*Duffie v. U.S.*,
600 F3d 326 (2010) . . . . . *passim*

*Durrett v. U.S.*,
71 F.3d 515 (5th Cir. 1996) . . . . . 42, 43

*Ertz v. C.I.R.*,
93 T.C.M. (CCH) 696 (2007) . . . . . 26

*Field v. U.S.*,
328 F.3d 58 (2nd Cir. 2003) . 22, 23, 27, 48

*Forseth v. C.I.R.*,
T.C. Memo. 1985-279,
1985 WL 14906 (1985) . . . . . 44, 45

*Frank Lyon Co. v. U.S.*,
435 U.S. 561
(1978) . . . . . 21, 29, 30, 36, 38, 41, 45

*Gardner v. C.I.R.*,
954 F.2d 836 (2d Cir. 1992) . . . . . 34

*Gilman v. C.I.R.*,
933 F.2d 143 (2d Cir. 1991) . . . . . 34

*Gregory v. Helvering*,
293 U.S. 465 (1935) . . . . . 21, 29, 36

*Hinck v. U.S.*,
550 U.S. 501 (2007) . . . . . 3, 14

*Horn v. C.I.R.*,
968 F.2d 1229 (D.C. Cir. 1992) . . . . 30, 32

*IES Indus., Inc., v. U.S.*,
253 F.3d 350 (8th Cir. 2001) . . . . . 34, 35

*Illes v. C.I.R.*,
982 F.2d 163 (6th Cir. 1992) . . . . . 33

*Jade Trading, LLC v. U.S.*,
598 F.3d 1372
(Fed.Cir. 2010) . . . . . 12, 23, 25, 26, 50

*James v. C.I.R.*,
899 F.2d 905 (10th Cir. 1990) ..... 33, 35

*Karr v. C.I.R.*,
924 F.2d 1018 (11th Cir. 1991) ..... 35

*Keener v. U.S.*,
551 F.3d 1358 Fed.Cir.),
*cert. denied*, — U.S. —,
130 S.Ct. 153,
175 L.Ed.2d 38 (2009) ..... 3-5, 19

*Keller v. C.I.R.*,
568 F.3d 710 (9th Cir. 2009) ..... 26, 27

*Kirchman v. C.I.R.*,
862 F.2d 1486 (11th Cir. 1989) ..... 35

*Klamath Strategic Inv. Fund ex rel.*
*St. Croix Ventures v. U.S.*,
568 F.3d. 537 (5th Cir. 2009) ..... 34, 38

*Kuralt v. U.S.*,
866 F.Supp. 727 (S.D.N.Y., 1994) ..... 48

*LeBlanc v. U.S.*,
90 Fed.Cl. 186 (2009) ..... 3, 4

*Lukens v. C.I.R.*,
945 F.2d 92 (5th Cir. 1991) . 34, 35, 42, 43

*Massengill v. C.I.R.*,
876 F.2d 616 (8th Cir. 1989) ..... 35

*Matthews v. U.S.*,
—F.Supp.3d—,
2010 WL 2305750
(S.D.Tex. June 8, 2010) . . . . . 2, 4, 14

*Maxwell v. C.I.R.*,
87 T.C. 783 (1986) . . . . . 3, 12

*McGann v. U.S.*,
76 Fed.Cl. 745 (2007) . . . . . 26, 27, 50

*McGann v. U.S.*,
81 Fed.Cl. 642 (2008) . . . . . 27, 47, 49, 50

*Monti v. U.S.*,
223 F.3d 76 (2nd Cir. 2000) . . . . . 28

*N.C.F. Energy v. C.I.R.*,
89 T.C. 741 (1987) . . . . . 12, 13, 22, 49

*Nault v. U.S.*,
517 F.3d 2 (1st Cir. 2008) . . . . . 3, 4

*Nicole Rose Corp. v. C.I.R.*,
320 F.3d 282 (2d Cir. 2003) . . . . . 34, 35

*Olson v. U.S.*,
172 F.3d 1311 (Fed. Cir. 1999) . . . . . 13

*Petaluma FX Partners, LLC v. C.I.R.*,
591 F.3d 649
(D.C.Cir. 2010) . . . . . 12, 23, 25, 26, 50

*Prati v. U.S.*,
603 F.3d 1301
(Fed.Cir. 2010) . . . . . 2, 4, 5, 14, 19, 23

*Prochorenko*,
243 F.3d 1359 (Fed.Cir. 2001) . . . . . 28

*Rexnord, Inc. v. U.S.*,
940 F.2d 1094 (7th Cir. 1991) . . . . . 35

*Rice's Toyota World, Inc. v. C.I.R.*,
752 F.2d 89 (4th Cir. 1985) . . . . 31, 32, 34

*River City Ranches #1, Ltd. v. C.I.R.*,
401 F.3d 1136 (9th Cir. 2005) . . . . . 26

*Sacks v. C.I.R.*,
69 F.3d 982 (9th Cir. 1995) . . . . . 35

*Schell v. U.S.*,
589 F.3d 1378
(Fed.Cir. 2009) . . . . . 2, 4, 19, 21, 26, 27

*Shriver v. C.I.R.*,
899 F2d 724 (8th Cir. 1990) . . . . . 33

*Thompson v. C.I.R.*,
631 F.2d 642 (9th Cir. 1980) . . . . . 35

*Todd v. C.I.R.*,
89 T.C. 912 (1987) . . . . . 7

*Treaty Pines Inv. Partnership v. C.I.R.*,
967 F.2d 206 (5th Cir. 1992) . . . . . 37

*United Parcel Serv. of Am., Inc. v. C.I.R.*,
254 F.3d 1014 (11th Cir. 2001) . . . . . 30

*Weiner v. U.S.*,
255 F.Supp.2d 673

(S.D. Tex. 2002) . . . . . 40, 43

*Weiner v. U.S.*,
389 F.3d 152 (5th Cir. 2004)
. . . 3-5, 9, 14, 15, 19, 22, 23, 40, 43, 46, 49

*White v. C.I.R.*, 95 T.C. 209 (1990) . . . . . 22

*Winn-Dixie Stores, Inc. v. C.I.R.*,
254 F.3d 1313
(11th Cir. 2001), *cert. denied*,
122 S.Ct. 1537 (2002) . . . . . 20, 31, 32

*Yosha v. C.I.R.*,
861 F.2d 494 (7th Cir. 1988) . . . . . 34

*Zfass v. C.I.R.*,
118 F.3d 184 (4th Cir.1997) . . . . . 22

## Statutes

26 U.S.C. §1092(c) . . . . . 44
26 U.S.C. §162 . . . . . 39
26 U.S.C. §174 . . . . . 39
26 U.S.C. §183 . . . . . 39
26 U.S.C. §6031 . . . . . 8
26 U.S.C. §6216(4) . . . . . 10
26 U.S.C. §6221 . . . . . 10
26 U.S.C. §6223 . . . . . 10
26 U.S.C. §6223(a)(2) . . . . . 9
26 U.S.C. §6223(d)(2) . . . . . 9
26 U.S.C. §6224(c) . . . . . 10, 11
26 U.S.C. §6226 . . . . . 10
26 U.S.C. §6226(a) . . . . . 10
26 U.S.C. §6226(b) . . . . . 10
26 U.S.C. §6226(c) . . . . . 10
26 U.S.C. §6226(d) . . . . . 10
26 U.S.C. §6226(d)(1)(A) . . . . . 10, 11
26 U.S.C. §6226(d)(1)(B) . . . . . 10
26 U.S.C. §6226(f) . . . . . 10, 24
26 U.S.C. §6226(g) . . . . . 11
26 U.S.C. §6226(h) . . . . . 11
26 U.S.C. §6228(a)(4)(B) . . . . . 10
26 U.S.C. §6229(a) . . . . . 22
26 U.S.C. §6230(a)(1) . . . . . 10
26 U.S.C. §6230(a)(2)(A)(i) . . . . . 49
26 U.S.C. §6230(c)(1)(A) . . . . . 6, 48
26 U.S.C. §6230(c)(2)(A) 15, 16, 46-48, 51, 52
26 U.S.C. §6230(d)(1) . . . . . 47

26 U.S.C. §6230(d)(6) . . . . . 46, 47
26 U.S.C. §6231(a)(3) . . . . . 8-10, 27
26 U.S.C. §6231(a)(4) . . . . . 8, 11
26 U.S.C. §6231(a)(5) . . . . . 8, 12
26 U.S.C. §6231(a)(6) . . . . . 6, 11, 49
26 U.S.C. §6404(e) . . . . . 14
26 U.S.C. §6511 . . . . . 45-47
26 U.S.C. §6601(e)(1) . . . . . 47
26 U.S.C. §6601(g) . . . . . 47
26 U.S.C. §6621(c) . . . . . *passim*
26 U.S.C. §6659 . . . . . 6, 46
26 U.S.C. §701 . . . . . 8
26 U.S.C. §702 . . . . . 8
26 U.S.C. §7422(h)

. . . . . 5, 11, 15, 19, 22, 23, 27- 29, 51, 52

26 U.S.C. §§6221-6233, the Tax Equity and Fiscal Responsibility Act of 1982, Pub.L. No. 97-248, 96 Stat. 324 ("TEFRA")

. . . . . 3, 8, 10, 12, 19, 24, 28, 43, 46, 52

28 U.S.C. §2401 . . . . . 47

Taxpayer Relief Act of 1997, P.L.105-34 §§1238(b) and 1239(b) . . . . . 9

**Rules and Regulations**

Tax Court Rules 245(b) and 247(a) . . . . . 10
Temp. Treas. Reg. §301.6221-1T(a) . . . . . 10
Temp. Treas. Reg. §301.6621-2T, A-4(1) . 39
Treas. Reg. §1.6031-1 . . . . . 8
Treas. Reg. §1.701-1 . . . . . 8
Treas. Reg. §1.702-1(a) . . . . . 8
Treas. Reg. §301.6621-2T . . . . . 6
Treas. Reg. §301.6621-2T, A-5 . . . . . 5, 49

**Other Authority**

135 Cong.Rec. S13057-03,
1989 WL 195142 (Cong.Rec.) . . . . . 7

H.R.Rep. No. 101-247,
1989 WL 168143 (Leg.Hist.) . . . . . 7

IRS Field Service Advisory 199950008,
1999 WL 1208429 . . . . . 10

Jeff Rector, *A Review of the Economic Substance Doctrine*,
10 STAN. J.L. BUS. & FIN. 173 . . . . . 36

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60 The Tax Lawyer 519 (2007) . . . . 31, 33

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## PETITION FOR A WRIT OF CERTIORARI

On behalf of John C. Duffie and Melissa Duffie, the undersigned counsel petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

## OPINIONS BELOW

The Fifth Circuit adopted and incorporated the unpublished opinion of the district court: *Duffie v. U.S.*, 600 F3d 326 (2010) ("*Duffie*"), *see* 2008 WL 4525370 (S.D.Tex. 2008), unpublished. App. 1-59.[1]

## JURISDICTION

The Fifth Circuit entered judgment on March 10, 2010. App.1. The Petition for Rehearing *En Banc* was denied May 14, 2010. App. 236-7. This Court has jurisdiction under 28 U.S.C. §1254(1).

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[1] References to "App. x" are to page "x" of the attached Appendix.

## STATUTES AND REGULATIONS INVOLVED

The relevant statutes, regulations, and rules are set forth in the appendix to this petition. App. 238-261.

## STATEMENT OF THE CASE

This case is one of at least four indirectly related petitions for writ of *certiorari* either currently before this Court or due to be filed this term. Each petition addresses partnership-related tax suits involving a group of limited partnerships generally referred to as the AMCOR partnerships.[2] These cases all

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[2] A petition for writ of *certiorari* was filed on July 7, 2010 related to *Schell v. U.S.*, 589 F.3d 1378 (Fed.Cir. 2009), rehearing denied April 8, 2010 (Fed.Cir #09-5010). App.196-208. A corrected petition was delivered to this Court on August 9, 2010. Separate petitions for writ of certiorari will be filed on or before November 1, 2010, related to *Prati v. U.S.* (Fed. Cir. #09-5117) and *Deegan v. U.S.* (Fed.Cir. #09-5129) arising from the combined opinion at *Prati v. U.S.*, 603 F.3d 1301 (Fed.Cir. 2010). Appeals are currently proceeding before the Fifth and Federal Circuits in *Matthews v. U.S.* (Fifth Cir. #10-20245) and *LeBlanc v. U.S.* (Fed.Cir. #10-5073), respectively. *See Matthews v. U.S.*, —F.Supp.3d—, 2010 WL 2305750 (S.D.Tex. June 8,

turn on resolving the existing confusion and conflicts in interpreting and applying TEFRA[3] unified partnership examination procedures.

Each AMCOR-related case addresses multiple issues that vary and overlap. These AMCOR cases, as well as other recent non-AMCOR partnership-related cases, turn on affected-item refund claim jurisdiction within TEFRA's statutory framework. The courts of appeal have reached conflicting opinions on

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2010) and *LeBlanc v. U.S.*, 90 Fed.Cl. 186 (2009). In addition, roughly 100 other directly and indirectly related AMCOR cases remain pending in various federal district courts, the Court of Federal Claims, and the Federal Circuit. The Fifth, Federal, and First Circuits have also addressed AMCOR-related cases at *Weiner v. U.S.*, 389 F.3d 152 (5th Cir. 2004), App. 209-235; *Keener v. U.S.*, 551 F.3d 1358 Fed.Cir.), *cert. denied*, — U.S. —, 130 S.Ct. 153, 175 L.Ed.2d 38 (2009), and *Nault v. U.S.*, 517 F.3d 2, 5 (1st Cir. 2008). Although *Hinck v. U.S.*, 550 U.S. 501 (2007) involved an AMCOR partner, the issue there is unrelated to any of the issues relevant here.

[3] Partnership procedures codified at 26 U.S.C. §§6221-6233 by the Tax Equity and Fiscal Responsibility Act of 1982, Pub.L. No. 97-248, 96 Stat. 324 ("TEFRA"). Effective for tax years after September 3, 1982. *See generally Maxwell v. C.I.R.*, 87 T.C. 783 (1986).

this issue, creating both inter-circuit and intra-circuit splits. The Duffies believe their case offers this Court the opportunity to resolve the fundamental legal issues of jurisdiction with a minimum of fact-based issues as well as the continuing confusion over the doctrines of "sham" and "lack of economic substance".

The AMCOR cases also involve issues that are unique to the type of refund claim. There are two general categories of AMCOR-related refund claims: (i) limitations and §6621(c)[4] claims for refund of all or part of the amounts assessed and collected following partial disallowance of investment year losses (*Duffie*, *Prati*, *Deegan*, *Weiner*, *Keener*, and *Matthews*) and (ii) basis claims seeking refunds based on the residual, outside basis loss suffered on termination or abandonment of partners' partnership interests in later years (*Schell*, *Nault*, and *LeBlanc*).

These categories are generally subdivided into "Individual Settlement" and "Agreed Decision" claims. As to §6621(c):

(i) the Individual Settlement claims arise

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[4] Unless otherwise stated, references to "Section," "sec.", "§" are to sections of the Internal Revenue Code at 26 U.S.C. (the "Tax Code").

from Form 870-P(AD) settlements and assert that applying §6621(c) and Treas.Reg. §301.6621-2T, A-5 proves no portion of their tax liability was "attributable to a tax motivated transaction" ("TMT") (*Weiner*, *Keener*, *Prati*); and

(ii) the Agreed Decision claims arise from partnership-level Tax Court decisions agreed to by the partnerships' tax matters partners ("TMPs"), not the individual partner, and assert those decisions did not agree to any TMT determinations; therefore, the resulting tax liability was not "attributable to" a TMT (*Duffie* and *Deegan*).

The "attributable to" a TMT issue is common to both types of §6621(c) claims but is based on different facts and legal arguments. *Duffie* is a §6621(c) penalty interest Agreed Decision claim.

The courts have reached conflicting results respecting the §6621(c) claims, in part, due to (i) fractures in interpretation and application of the "lack of economic substance" and/or sham transaction doctrines, (ii) the meanings and scope of "attributable to" in §6621(c) and §7422(h), and (iii) differences in the

interpretation of the §6231(a)(6) definition of "computational adjustment," especially as used in the §6230(c)(1)(A) 6-month limitations period for filing refund claims. These issues are addressed below.

## 1. Section 6621(c) Overview

Former §6621(c) imposes interest at 120% of the standard rate on tax underpayments that exceed $1000 and are "attributable to" any TMT specifically listed in §6621(c) and Treas. Reg. §301.6621-2T. Two TMTs listed in §6621(c)(3)(A) are:

> (iv) use of an accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period, and
>
> (v) a sham or fraudulent transaction.

Neither §6621(c) nor the accompanying regulation lists "lack of economic substance" as a TMT. *Duffie* conflated "lack of economic substance" with the TMT "sham".

Congress enacted §6621(c) and other accuracy related penalties (*e.g.* §6659) to encourage settlements and lighten the Tax

Court's docket.[5] Congress repealed §6621(c) and modified other accuracy penalties just five years after enactment, because it found they were a "morass of inconsistency and irrationality ... determined too routinely and automatically by the IRS,"[6] and contravened Congress's intent and

discouraged rather than encouraged compliance.[7] But §6621(c) was not repealed retroactively. The IRS continues to vehemently impose it for years 1984-1989.

## 2. Overview of TEFRA Jurisdiction

Partnerships generally do not pay income

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[5] *See Todd v. C.I.R.*, 862 F.2d 540, 544 and n.14 (5th Cir. 1988) and *Todd v. C.I.R.*, 89 T.C. 912, 916-18 (1987).

[6] Statement by Senator Pryor introducing S.1784 at 135 Cong. Rec. S13893-7 (October 24, 1989), 1989 WL 186980 (Cong.Rec.). S.1784 was ultimately enacted as a part of P.L. 101-239.

[7] H.R.Rep. No. 101-247, 1388, 1393-5, 1989 WL 168143 (Leg.Hist.), **2863,*1393, 135 Cong.Rec. S13057-03, 1989 WL 195142 (Cong.Rec.) *S13175, *cited by Copeland v. C.I.R.*, 290 F.3d 326, 330 n. 10 (5th Cir. 2002).

tax; they file information returns.[8] Each partner recognizes his share of partnership income, gains, losses, *etc.*, on his individual return.[9] Before 1982 the IRS separately examined each partner's return and could not ensure consistent treatment of items on the partnership return. Congress enacted TEFRA to consolidate some partnership audit and adjustment procedures of a partnership's tax return.

TEFRA mandates mutually exclusive categories of "partnership items" and "nonpartnership items."[10] Any item with both partnership item and nonpartnership item components is classified as an "affected item," a subcategory of nonpartnership items.[11] For the pre-1997 tax years at issue, TEFRA bifurcates the procedures for adjustment, judicial review, assessment, and refund of

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[8] *Conway v. U.S.*, 50 Fed.Cl. 273, 276 2001).

[9] §§701, 702, 6031; Treas.Reg.§1.701-1; 1.702-1(a); 1.6031-1.

[10] §6231(a)(3) and (a)(4). App.249.

[11] §6231(a)(5). App.249.

partnership items and affected items.[12]

**a. Partnership Item Jurisdiction**

"Partnership item"is defined as:

> any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle [F], such item is more appropriately determined at the partnership level than at the partner level.[13]

To adjust a partnership item, the IRS must first issue a Notice of Final Administrative Adjustment ("FPAA").[14] A suit to contest partnership-item adjustments must be brought

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[12] See *Callaway v. C.I.R.*, 231 F.3d 106,107-113 (2nd Cir. 2000) and *Weiner*, at 154-55. This bifurcated system was somewhat amended, effective for tax years beginning after August 5, 1997, but not applicable here. Taxpayer Relief Act of 1997, P.L.105-34 §§1238(b) and 1239(b).

[13] §6231(a)(3). App.249.

[14] §§6223(a)(2) and (d)(2). App.239.

at the partnership level.[15] For pre-1997 tax years, subject-matter jurisdiction in a partnership-level suit is expressly restricted to the readjustment and allocation of partnership items.[16] TEFRA mandates that partnership items be determined at the partnership level before affected items, including §6621c) penalty interest, are addressed.[17]

But, by statute, two categories of partners are not parties in their partnership's partnership-level suit: 1) those whose partnership items have converted to nonpartnership items (usually by settlement or bankruptcy), and 2) those whose assessment period has expired.[18] Because they are not parties, those partners cannot be bound by the partnership-level suit.[19]

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[15] §6221. App.238.

[16] §§6226(a), (b), and (f). App.242-4..

[17] §§6216(4), 6221, 6223, 6224(c), 6225(a), 6226, 6230(a)(1), 6231(a)(3), App.238-50; Temp.Treas.Reg. §301.6221-1T(a), App.254; *Callaway*, 231 F.3d at 110.

[18] §6226(c). App. 243. §6226(d)(1)(A) and (B). App. 243-4.

[19] §§6226(d) and 6228(a)(4)(B), App.243-5; Tax Court Rules 245(b) and 247(a), App. 259. IRS Field Service

After the partnership items are determined, the IRS calculates the partner's share of the partnership-item adjustments, makes the corresponding adjustments to the individual partner's return, and assesses any tax against the partner.[20] In any later partner-level proceeding, the partnership-item determinations can be applied but cannot be substantively challenged by the partner or the IRS.[21] Accordingly, §7422(h) bars jurisdiction over partner-level claims for any "refund attributable to partnership items."

### b. Nonpartnership Item and Affected Item Jurisdiction

A nonpartnership item is any "item which is (or is treated as) not a partnership item."[22] There are two types of nonpartnership items:

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Advisory 199950008, 1999 WL 1208429, December 17, 1999. Section 6226(d)(1)(A) terminates jurisdiction upon settlement or bankruptcy regardless of whether the partner participates.

[20] A process defined as a "computational adjustment" at §6231(a)(6). App. 249.

[21] §§6224(c), 6226(g) and (h), 7422(h). App. 240 and 253. *See Jade Trading*, 80 Fed.Cl. 11, 42 n.62 (2007).

[22] §6231(a)(4). App. 249.

pure nonpartnership items and affected items.

Pure nonpartnership items are items completely unrelated to the partnership, *e.g.*, rental income from nonpartnership property. Adjustments to partnership items do not alter pure nonpartnership items. After the partner's partnership items are determined, that partner's affected item *non*partnership items are then addressed, usually under the normal subchapter B deficiency procedures.[23]

An affected item is "any item to the extent such item is affected by a partnership item."[24] Some affected items have partnership-item and nonpartnership-item components. But only the partnership-item component can be determined at the partnership-level; the nonpartnership, partner-level component must be determined at the partner level.[25] Partner-

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[23] *Maxwell*, 87 T.C. at 788; *Callaway*, 231 F.3d at 108, 110; §6230 (non-TEFRA procedures of §§6211-6216 apply to assessments attributable to affected items not assessable by means of computational adjustments.).

[24] §6231(a)(5). App. 249. It is well settled that *some* affected items have a partnership item *component*. *See N.C.F. Energy v. C.I.R.*, 89 T.C. 741, 743-4 (1987).

[25] *See Jade Trading, LLC v. U.S.*, 598 F.3d 1372 (Fed.Cir. 2010), App. 111-33; *Petaluma FX Partners,*

level jurisdiction over an affected item cannot be foreclosed simply because a partnership-item component was previously determined at the partnership level.

As discussed below, prior to these AMCOR refund-related decisions, it was well-settled and the Government had conceded that partner-level determinations must be made before the IRS can impose the §6621c) penalty rate of interest. In *Duffie* the court repeatedly iterated that whether an underpayment of tax is "attributable to" a TMT is a partner-level determination. App. 38, 43, 46, 47.

**3. History of This Case**

AMCOR organized over 200 limited partnerships. John C. Duffie invested as a limited partner in one, Texas Farm Venturers ("TFV").

In the 1980s, the IRS proposed adjustments to only 43 AMCOR partnerships, including TFV for 1984. The adjustments were challenged in the Tax Court. The Duffies were treated as parties to the TFV Tax Court suit.

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*LLC v. C.I.R.*, 591 F.3d 649 (D.C.Cir. 2010), App. 157-174; and *Olson v. U.S.*, 172 F.3d 1311, 1317-18 (Fed. Cir. 1999), *citing N.C.F. Energy*, 89 T.C. at 744.

While those suits were pending, the IRS solicited partnership-item settlements from the AMCOR partners. Some accepted. Others, like the Duffies, did not and were treated as continuing parties to the partnership-level proceedings. The IRS eventually moved to enter agreed decisions. The Tax Court granted the IRS's motions and entered the proposed decisions, including the "TFV Decision."

The IRS assessed tax and interest against the Duffies, relying on the TFV Decision. But interest was assessed at the §6621(c) penalty rate. The Duffies paid in full and then filed claims for refund asserting, *inter alia*, that as a matter of law the TFV Decision did not support §6621(c) penalty interest, the only portion of their claims still in issue.[26] The IRS denied that claim.

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[26] The refund claim asserted other alternative grounds for recovery, including the statute of limitations and abatement under §6404(e). The Duffies voluntarily dismissed the limitations and abatement claims pursuant to *Weiner* and *Hinck*, respectively. Recent decisions respecting the partnership-related limitations period for assessment have reopened the limitations issue for other partners, to be addressed in the *Prati* and *Deegan* petitions for *certiorari* and currently on appeal before the Fifth Circuit in *Matthews*.

The Duffies filed suit in the Southern District of Texas and moved for summary judgment citing the Fifth Circuit's determination in *Weiner* that §6621(c) interest was improperly imposed as a matter of law against the Individual Settlement partners. They asserted the TFV Decision agreed only that the adjustments were attributable to transactions lacking economic substance, which is not a TMT. The Government cross-moved, asserting *Weiner* controls only Individual Settlement claims and the Duffies' Agreed Decision claim was (i) barred by *res judicata*. (ii) barred by §7422(h), and (ii) untimely under §6230(c)(2)(A).

The trial court denied the Duffies' motion, granted the Government's, and entered final judgment, finding the TFV Decision established sham as the ground for the adjustment and holding *res judicata* barred relitigation of the issue. The court also held that the "attributable to" a TMT issue was answered by the sham finding and "relitigation" of sham was barred by §7422(h). The court determined the only issue it could consider was whether the underpayment exceeded $1000 and any such claim was untimely under the §6230(c)(2)(A)'s 6-month deadline.

The Duffies appealed. The Fifth Circuit affirmed and adopted the trial court's opinion. The Duffies petitioned for rehearing *en banc*, asserting: (i) the court erroneously conflated lack of economic substance with sham and omitted any consideration of profit motive/business purpose in holding the TFV Decision established sham as the grounds for adjustment; (ii) the court erred in holding the §6621(c) affected item claim was barred by §7422(h), even if sham was the ground for the partnership-level adjustment; and (iii) §6230(c)(2)(A)'s 6-month filing deadline applies only to claims for erroneous computations of computational adjustments, *i.e.*, math mistakes in computing a partner's individual liability attributable to partnership items. The Fifth Circuit denied the petition on May 14, 2010.

**4. Facts**

The IRS issued FPAAs for 43 AMCOR partnerships, proposing multiple, alternative, and sometimes mutually exclusive grounds to totally disallow the partnership's deductions. TFV's 1984 FPAA listed 15 alternative grounds for adjustment of the deductions, including:

1. The partnership's activities constitute a series of sham transactions.

2. The partnership's activities lack economic substance.

App.262.

The FPAA stated, "[i]n the alternative, if the partnership activities are determined to constitute a valid trade or business, then ... [t]he partnership incurred no bona fide debt and made no bona fide loans with respect to its trade or business of farming."

App. 263.

The IRS drafted and filed a "Motion for Entry of Decisions Pursuant to [Tax Court] Rule 248(b)" in the TFV suit that, for 1984, allowed 56% of TFV's Farming Expenses and 100% of TFV's Other Deductions. For 1985, it agreed millions in expenses, costs, and other deductions were proper. The relevant TFV Decision language stated:

> [t]hat the [1984] adjustments to partnership income and expense ... are attributable to transactions which lacked economic substance, as described in former I.R.C. §6621(c)(3)(A)(v), so as to result in a substantial distortion of income and expense, as described in I.R.C. §6621(c)(3)(A)(iv), when computed under the partnership's cash receipts and

disbursements method of accounting; and

That liabilities in the amount of $5,802,914 *lack economic substance*;...

App. 269. [Emphasis added.]

The TFV Decision agreed *only* to lack of economic substance to disallow *part* of the 1984 liabilities and corresponding expenses, and did not agree to the FPAA's alternative sham ground. As illustrated by its separate iteration in the FPAA, lack of economic substance is an independent, narrower ground for adjustment than sham. Agreeing to lack of economic substance of part of the loans avoided litigation of the "sham" and other grounds for adjustment. The disallowed expenses are those dependent on the proceeds of loans agreed to lack economic substance. TFV's FPAA disallowed the loans *only* if TFV's activities *were* determined to be a valid trade or business. The expense disallowances were "attributed to" the loans that "lack economic substance." That distinction in the agreed decision was not mere semantics.

## REASONS TO GRANT THE PETITION

In *Duffie* the Fifth Circuit erred in holding that a partnership-level determination is

sufficient for §7422(h) to jurisdictionally bar a partner-level affected-item refund claim. This same issue is addressed in the *Schell* petition for writ of *certiorari* and the soon to be filed petitions in *Deegan* and *Prati*.

The TEFRA partnership procedures affect millions of partnerships and partners. Virtually all are directly impacted by this escalating uncertainty as to TEFRA partnership item and affected-item jurisdiction.

The *ad hoc* approach to TEFRA jurisdiction has left similarly situated taxpayers with substantially identical claims with inconsistent jurisdictional outcomes. This jurisdictional uncertainty leave taxpayers, the Government, and the courts without guidance, has needlessly multiplied litigation, and undermined the integrity of the tax system. This issue was the subject of the *Weiner*, *Keener*, and, *Curr-Spec*[27] petitions for *certiorari*.

Hundreds of AMCOR partners filed §6621(c) and limitations claims. Each of the

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[27] *Curr-Spec Partners, L.P. v. C.I.R.*, 579 F.3d 391 (5th Cir. 2009), *cert. denied*, — U.S. —, 130 S.Ct. 3321, — L.Ed.2d — (2010).

judicially reviewed claims has resulted in different jurisdictional outcomes and/or approaches.

Moreover, the Fifth Circuit erred in adopting the trial court's determination that the TFV Decision established sham as the grounds for adjustment. The agreed decisions state on their faces that the adjustments were attributable to lack of economic substance. In the past decade, at least four petitions for *certiorari* have asked for guidance regarding the lack of economic substance and sham transaction doctrines.[28] These doctrines have erroneously been used interchangeably and indiscriminately conflated by the IRS and the courts.

In addition to conflating those doctrines, most authorities are divided as to their underlying factors, business purpose/profit

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[28] *Cemco Investors, L.L.C. v. U.S.*, 515 F.3d 749 (7th Cir. 2007), *cert. denied*, 129 S.Ct. 131 (2008)(petition at 2008 WL 2724494); *Dow Chem. Co. v. U.S.*, 435 F.3d 594 (6th Cir. 2006), *cert. denied*, 127 S.Ct. 1251 (2006)(petition at 2006 WL 2827288); *Coltec Ind., Inc. v. U.S.*, 454 F.3d 1340 (Fed.Cir.2006), *cert. denied*, 127 S.Ct. 1261 (2006) (petition at 2006 WL 3295204); *Winn-Dixie Stores, Inc. v. C.I.R.*, 254 F.3d 1313, 1316 (11th Cir. 2001), *cert. denied*, 122 S.Ct. 1537 (2002)(petition at 2002 WL 32135968).

motive and economic substance. It seems abundantly clear overall that there is some hierarchy of badness and related culpability for transactions that are disallowed because the transaction is a fraud, sham, or lacks economic substance. Most courts analyzing "sham" find some additional factor necessary to elevate a transaction "lacking economic substance" to a "sham", and an even greater level of intent to elevate it to civil or criminal fraud.

*Gregory* itself was a "sham" case involving elements beyond economic substance.[29] *Frank Lyon* concerned purely "lack of economic substance" to the form of the transaction.[30] Lack of economic substance, sham, and fraud all disallow the deduction but with dramatically different penalties applicable. Thus, this Court's guidance is desperately needed as to this issue.

**1. Section 7422(h) Does Not Bar Affected Item Claims**

As discussed in the *Schell* petition, there have been three AMCOR-related basis claims

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[29] *Gregory v. Helvering*, 293 U.S. 465 (1935). App. 105-10.

[30] *Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1978). App. 67-104.

addressed by various courts with three different jurisdictional outcomes.

There is a similar jurisdictional split respecting §6621(c) claims. In *Weiner* the Fifth Circuit held the §6229(a)-based "limitations period" to assess tax attributable to partnership items is itself a partnership item and affirmed dismissal of that claim pursuant to §7422(h). Clearly the Fifth Circuit reviewed §7422(h) in the *Weiner* case and could have raised §7422(h) *sua sponte* as to the §6621(c) claim. Instead it held the IRS improperly imposed §6621(c) against the settled AMCOR partners as a matter of law.

Since 1987 the Tax Court has consistently held it lacks jurisdiction to make §6621(c) determinations in a partnership-level proceeding because §6621(c) is not a partnership item and not within the scope of partnership-level proceedings.[31] The Second and Fourth Circuits have likewise held §6621(c) interest is not a partnership item.[32] In

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[31] *N.C.F. Energy*, 89 T.C. at 744-5. See also *Affiliated Equip. Leasing II v. C.I.R.*, 97 T.C. 575, 576-8 (1991), citing *White v. C.I.R.*, 95 T.C. 209, 212 (1990).

[32] *Field v. U.S.*, 328 F.3d 58, 60 (2nd Cir. 2003), App. 60-66; *Zfass v. C.I.R.*, 118 F.3d 184, 192 (4th

*Field*, the Second Circuit recognized and accepted 20 years of precedent establishing §6621(c) is an affected item with both partnership and nonpartnership item components. The Second Circuit expressly held partner-level §6621(c) refund claims are not barred by §7422(h). *Weiner* followed precedent that §6621(c) refund claims can only be brought at the partner-level. *Duffie* (and *Prati* and *Deegan*) conflict with this established precedent.

In the AMCOR cases other than *Weiner*, the Government did not dispute that precedent but asserted the alleged partnership-level, partnership-item determinations were enough to jurisdictionally bar the partners' §6621(c) refund claims. But that approach – reliance on an alleged partnership-level determination to bar a partner-level, affected item claim – was rejected by the D.C. Circuit and the Federal Circuit in *Petaluma* and *Jade Trading*.

In *Petaluma*, the D.C. Circuit construed affected-item basis claims from the partnership level. There the Government conceded outside basis is an affected item but argued that because the elements of basis are

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Cir.1997).

mainly partnership items the Tax Court had jurisdiction to make the allegedly "obvious conclusion" that a partner could not have any basis given the sham/lack of economic substance finding. The Tax Court found the partnership was a sham, lacked economic substance, and should be disregarded for tax purposes and further held that the partners had no personal basis in the partnership.

The D.C. Circuit afirmed the sham determination but reversed as to basis, recognizing that under §6226(f) only partnership items can be reviewed in a partnership-level TEFRA suit and a partner's "outside basis" is an affected item. It held the Tax Court had no jurisdiction to make the basis determination at all, stating:

> The fact that a determination seems obvious or easy does not expand the court's jurisdiction beyond what the statute provides. *In other words, it does not matter how low the fruit hangs when one is forbidden to pick it.* We hold that the Tax Court had no jurisdiction to determine that Petaluma's partners had no outside basis in the disregarded partnership. . . . If disregarding a partnership leads ineluctably to the conclusion that its partners have no

> outside basis, that should be just as obvious in partner-level proceedings as it is in partnership-level proceedings.

App. 171. [Emphasis added.]

Shortly thereafter, the Federal Circuit issued *Jade Trading*. There, the Court of Federal Claims had held the partnership's transactions lacked economic substance and should be disregarded for tax purposes. The Government asserted affected-item penalties related to the partners' outside basis could be determined at the partnership level because most (if not all) of the components of basis are partnership items, including the legal and factual determinations that underlie the characterization of partnership items as lacking economic substance. The trial court held for the Government. The Federal Circuit affirmed as to lack of economic substance but reversed as to the penalties, recognizing outside basis is an affected item that can only be determined at the partner level. App. 128-9. *Jade Trading* followed *Petaluma*, including the portion of the decision that explained §6230(c)(1) allows partners to challenge the *application* of the partnership-level, partnership-item determinations to their affected items. This is the fundamental issue in *Duffie*.

*Schell* and *Duffie* cannot be reconciled with *Petaluma* and *Jade Trading*.

Conflicts as to §6621(c) affected-item jurisdiction exist in other non-AMCOR cases. In *River City Ranches*, the Ninth Circuit held the §6621(c) partnership-item components are determined at the partnership-level.[33] In *Ertz*, the Tax Court applied *River City* erroneously to hold partner-level, §6621(c) claims must be brought at the partnership-level.[34] But on appeal *sub nom* in *Keller*, the Ninth Circuit clarified that the partner-level court may and should address whether §6621(c) can be applied based on the partnership-level determinations.[35]

Several other non-AMCOR cases have followed this jurisdictional approach. The Fifth Circuit ordered refund of the overpaid §6621(c) penalty interest in *Copeland* as did the Court of Federal Claims in *McGann* and the District

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[33] *River City Ranches #1, Ltd. v. C.I.R.*, 401 F.3d 1136 (9th Cir. 2005).

[34] *Ertz v. C.I.R.*, 93 T.C.M. (CCH) 696 (2007).

[35] *Keller v. C.I.R.*, 568 F.3d 710 (9th Cir. 2009).

Court in *Bartimmo*.[36]

In *Keller*, the Ninth Circuit recognized that barring partner-level, affected-item claims would leave taxpayers with no review of erroneously imposed §6621(c) interest. In *Barlow* the Sixth Circuit reached the same conclusion and held taxpayer Fifth Amendment due process rights were not violated because taxpayers have a *post*-payment, refund forum.[37] *Schell* and *Duffie* eviscerate that due process safety net.

*Schell* and *Duffie* are also inconsistent with Second Circuit and Federal Circuit precedent regarding the scope of §7422(h). In *Field*, the Second Circuit refused to expand §7422(h) to encompass claims for refund that are *capable* of being attributed to partnership items. The court reasoned the parenthetical reference to §6231(a)(3) in §7422(h)'s meant jurisdiction is barred only if the refund itself (not the item

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[36] *McGann v. U.S.*, 76 Fed.Cl. 745 (2007); *McGann v. U.S.*, 81 Fed.Cl. 642 (2008); *Bartimmo v. U.S.*, 525 F.Supp.2d 879 (S.D.Tex. 2007). The Government appealed *McGann* to the Federal Circuit (No.08-5086) and *Bartimmo* to the Fifth Circuit (No. 08-20060), but voluntarily dismissed those appeals.

[37] *Barlow v. C.I.R.*, 301 F.3d 714 (6th Cir. 2002).

which leads to that refund) is attributable to partnership items. App. 63-5.

In *Prochorenko*, the Federal Circuit followed another Second Circuit §7422(h) decision that recognized, while the partner sought a refund of partnership-related taxes, the refund was not "attributable to" partnership items.[38] The Federal Circuit adopted the Second Circuit's observation that "at some level of generality, most refund claims for partnership taxes can be characterized as a refund 'attributable to partnership items,' " and held that construing that phrase so broadly would be contrary to the system of TEFRA's separate treatment of partnership and nonpartnership items. App. 183-4. As *Prochorenko* and *Monti* realized, to some extent all affected-item refund claims seek recovery of tax liability that is "attributable to" partnership items. But where the grounds for the refund are not based on the partnership item determination but on how that determination was applied to the partner (or on other independent grounds), then §7422(h) should not bar the claim. This issues needs this Court's guidance.

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[38] *Prochorenko*, 243 F.3d 1359, 1363 (Fed.Cir. 2001), *citing Monti v. U.S.*, 223 F.3d 76, 82 (2nd Cir. 2000). App. 175-195 and 134-156.

In *Duffie* the Government agreed and the court iterated no less than five times that whether tax is "attributable to" a TMT is a partner-level determination. Contrary to its 7422(h) holding, the court in *Duffie* did exercise jurisdiction to find, *albeit* erroneously, TFV Decision's language established that sham, a TMT, was the sole ground for adjustment. App. 39. The §7422(h) ruling should be reversed for precedential purposes even if the sham holding is sustained.

**2. Lack of Economic Substance and Sham are Distinct Tax Doctrines**

Since this Court first disregarded "sham transactions without economic substance ... for tax purposes" in *Gregory*, the common-law sham and economic substance doctrines have had a tortured history marred by confusion and uncertainty. In *Gregory*, this Court affirmed a stock transfer was really a dividend and held such "an elaborate and devious form of conveyance masquerading as a corporate reorganization" is a "transaction [that] upon its face lies outside the plain intent of the statute."[39]

But later, in *Frank Lyon*, this Court

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[39] *Gregory*, 293 U.S. at 470.

recognized that

> [w]here ... there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.[40]

The courts have struggled to reconcile *Gregory* and *Frank Lyon*. Courts have variously referred to and conflated the doctrines that emerged as the economic-substance[41] and/or the sham-transaction doctrine.[42] Some courts refer to the sham-transaction doctrine as the overall test, consisting of a subjective inquiry into "business purpose"/"profit motive"and an objective

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[40] *Frank Lyon Co. v. U.S.*, 435 U.S. 561, 583-84 (1978).

[41] *United Parcel Serv. of Am., Inc. v. C.I.R.*, 254 F.3d 1014, 1018 (11th Cir. 2001).

[42] *Horn v. C.I.R.*, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992).

inquiry into "economic substance."[43] While others refer only to "economic substance" as the overall test and struggle with the same subsidiary "business purpose"/"profit motive"and "economic substance" inquiries.

The IRS aggressively and indiscriminately exploits this conflict and asserts sham and economic substance interchangeably on an *ad hoc* basis to avoid technical analysis of the Tax Code. The unpredictable interpretation and application of those doctrines has left taxpayers buffeted, without guidance or a reliable touchstone.

As the many petitions for *certiorari* on this issue make clear, in addition to the confusion over whether there are one or two separate doctrines, the circuits have divided over whether this Court mandated a "conjunctive," "disjunctive," or "unitary" test regarding the business purpose/profit motive and economic substance inquiries in order to apply the doctrine(s).[44]

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[43] *See, e.g., Winn-Dixie*, 254 F.3d at 1316; *Rice's Toyota World, Inc. v. C.I.R.*, 752 F.2d 89, 91-92 (4th Cir. 1985).

[44] See, Leland I. Gardner, *An Elephant in the Room: Double Deductions and the Economic Substance*

The Fourth and D.C. Circuits have adopted a two-prong "conjunctive" test.[45] In *Rice's* the Fourth Circuit held:

> To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists.[46]

The Sixth, Eleventh, and Federal Circuits have adopted a "disjunctive" test, holding the absence of either economic substance or business purpose/profit motive is fatal to the transaction.[47]

The Third, Ninth, and Tenth Circuits employ a "unitary" test that does not consider

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*Doctrine in Coltec Industries, Inc. V. U.S.*, 60 The Tax Lawyer 519, 525 (2007); Yoram Keinan, *The Many Faces of the Economic Substance's Two-Prong Test: Time For Reconciliation?*, 1 NYU J.L. & Bus. 371, 407-16 (2005).

[45] *Rice's, supra.*; *Horn, supra.*

[46] *Rice's*, 752 F.2d at 91.

[47] *Winn-Dixie*, 254 F.3d at 1316; *Dow Chem.*, 435 F.3d at 599; and *Coltec*, 454 F.3d at 1355.

business purpose or economic substance as distinct prongs but interrelated factors:

> [The] distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.[48]

But even these groupings are arbitrary. Some scholars classify the groups differently.[49]

Some circuits articulate a test but cite conflicting support and fail to distinguish intra-circuit conflicts. For example, the Fifth Circuit initially acknowledged the inter-circuit conflict but declined to adopt an approach.[50]

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[48] *ACM Partnership v. C.I.R.*, 157 F.3d 231, 247 (3d Cir. 1998), quoting *Casebeer v. C.I.R.*, 909 F.2d 1360, 1363 (9th Cir. 1990). *James v. C.I.R.*, 899 F.2d 905, 909 & n.5 (10th Cir. 1990).

[49] Gardner, *supra*, citing *Illes v. C.I.R.*, 982 F.2d 163, 165 (6th Cir. 1992) and *Shriver v. C.I.R.*, 899 F2d 724, 725-6 (8th Cir. 1990) as members of the conjunctive circuits.

[50] *Compaq Computer Corp. v. C.I.R.*, 277 F.3d 778, 781-2 (5th Cir. 2001).

That court recently rejected *Rice*'s conjunctive test to hold "a lack of economic substance is sufficient to invalidate the transaction regardless of whether the taxpayer has motives other than tax avoidance," but cited and relied on both disjunctive and unitary precedent.[51] Moreover, *Klamath* did not address Fifth Circuit precedent that followed *Rice*'s conjuctive approach and took into account profit motive as a factor in deciding sham.[52] *Duffie* adopted this confusing analysis from *Klamath*.

Other circuits conflict internally.[53] The First, Seventh, and Eighth Circuits have failed to articulate a test.[54]

The circuits are also spilt as to subsidiary

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[51] *Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. U.S.*, 568 F.3d. 537, 544 (5th Cir. 2009).

[52] *Lukens v. C.I.R.*, 945 F.2d 92 (5th Cir. 1991).

[53] *See Nicole Rose Corp. v. C.I.R.*, 320 F.3d 282, 284 (2d Cir. 2003); *Gardner v. C.I.R.*, 954 F.2d 836, 839 (2d Cir. 1992) (per curiam); *Gilman v. C.I.R.*, 933 F.2d 143, 147 (2d Cir. 1991).

[54] *Dewees v. C.I.R.*, 870 F.2d 21 (1st Cir. 1989); *Yosha v. C.I.R.*, 861 F.2d 494 (7th Cir. 1988); and *IES Indus., Inc., v. U.S.*, 253 F.3d 350, 353-4 (8th Cir. 2001).

issues, *e.g.*, what is necessary to show objective economic substance.[55] At least five circuits hold economic substance is a fact question and review for clear error.[56] Other circuits review economic substance determinations *de novo*.[57] *Duffie* followed *Coltec*. Four circuits are internally divided and apply conflicting standards of review.[58] Some circuits have

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[55] *See, e.g., ACM*, 157 F.3d at 235 n.6 and *Bail Bonds by Marvin Nelson, Inc. v. C.I.R.*, 820 F.2d 1543, 1549 (9th Cir. 1987).

[56] *Rexnord, Inc. v. U.S.*, 940 F.2d 1094, 1096 (7th Cir. 1991); *Comdisco v. U.S.*, 756 F.2d 569, 575 (7th Cir. 1985); *Nicole Rose*, 320 F.3d at 284; *ACM*, 157 F.3d at 245; *Black & Decker Corp. v. U.S.*, 436 F.3d 431, 441 (4th Cir. 2006); *ASA Investerings P'ship v. C.I.R.*, 201 F.3d 505, 511 (D.C. Cir. 2000).

[57] *Coltec*, 454 F.3d at 1357 (economic substance conclusion reviewed *de novo* but facts reviewed for clear error); *James*, 899 F.2d at 909 & n.5; *Dow Chem.*, 435 F.3d at 599 & n.8.

[58] *Compare, e.g., Lukens*, 945 F.2d at 97, with *Compaq*, 277 F.3d at 780-81; *Massengill v. C.I.R.*, 876 F.2d 616, 619 (8th Cir. 1989), with *IES Indus.*, at 351; *Thompson v. C.I.R.*, 631 F.2d 642, 646 (9th Cir. 1980), with *Sacks v. C.I.R.*, 69 F.3d 982, 986 (9th Cir. 1995); and *Karr v. C.I.R.*, 924 F.2d 1018, 1023 (11th Cir. 1991), *with Kirchman v. C.I.R.*, 862 F.2d 1486, 1490 (11th Cir. 1989).

adopted presumptions either in favor or against taxpayers when considering whether a transaction is a sham or lacks economic substance.[59]

Further complicating this issue is another type of sham, sometimes referred to a sham-in-fact, which is more akin to fraud. The courts have distinguished this type of sham in *dicta*, but not in practice and have conflated the principles for testing sham-in-fact with sham and economic substance as articulated in *Gregory* and *Frank Lyon*.[60]

There is absolutely no coherent precedent guiding these common-law doctrines. The IRS is aggressively exploiting this haphazardness and indiscriminately using sham and economic substance as blunt instruments to disallow or recharacterize transactions. Taxpayers are left with no guidance for tax planning or any subsequent defense as the courts have failed to

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[59] Jeff Rector, *A Review of the Economic Substance Doctrine*, 10 STAN. J.L. BUS. & FIN., 173, n.69 at 178 (the Third, Fourth, and Seventh Circuits employ a pro-taxpayer presumption while the Second, Sixth, Eighth, Ninth, Tenth, and D.C. Circuits employ a presumption that the transaction fails).

[60] *Compaq*, 277 F.3d at 781, n. 1.

distill any cogent legal principles to govern these judicially created doctrines.

In agreeing only to "lack of economic substance", the TMP for TFV did not agreed to "sham." In the TFV FPAA, the IRS proposed to disallow the same transaction on two separately-stated, independent grounds: sham and lack of economic substance. The agreed TFV Decision is explicit that lack of economic substance of the liabilities is the basis for the adjustments. The IRS and TMP were well aware individual partners were already defending against §6621(c) and "sham" based on their profit motives. The agreed decision was a contract and should have been interpreted based on the intent of the parties.[61]

For purposes of allowing or disallowing deductions, the distinctions between fraud, sham, and "lack of economic substance" are irrelevant. In all three cases, the transaction is disregarded and the deductions disallowed. But for §6621(c) purposes the distinctions are critical. Fraud carries very serious, sometimes criminal sanctions. "Sham" is defined as a TMT and "lack of economic substance" is not.

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[61] *Alexander v. U.S.*, 44 F.3d 328, 331 (5th Cir. 1995); *Treaty Pines Inv. Partnership v. C.I.R.*, 967 F.2d 206, 211 (5th Cir. 1992).

In *Klamath* the Fifth Circuit correctly concluded lack of economic substance alone will result in a transaction being disregarded. In *Battelstein*, the court affirmed disallowance of the deductions for lack of economic substance, holding "we look through the form in which the taxpayer has cloaked a transaction to the substance of the transaction."[62] But *Battelstein* further held:

> For business men to defer payment of interest obligations in the way the Battelsteins have done may well be a sensible way in which to do business. Whether it is or is not, what is relevant here is that interest obligations so deferred cannot be claimed for tax purposes as interest obligations paid.[63]

Both *Klamath* and *Battelstein* dealt only with whether partnership item losses should be disallowed for lack of economic substance, not whether penalty interest should be imposed. For §6621(c) the distinction between "sham" and "lack of economic substance" is critical. Had *Frank Lyon* or *Battelstein* been

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[62] *Battelstein v. C.I.R.*, 631 F.2d 1182, 1184 (5th Cir. 1980).

[63] *Id.*, at 1184-5.

subject to §6621(c), the transactions would not have been "attributable to" a sham transaction although the deductions were disallowed based on a lack of economic substance. The disallowance in *Duffie* is analogous.

The importance of this distinction and the error of conflating grounds for adjustment can be seen by analogy to *Copeland* where the IRS similarly attempted to impose §6621(c) by simple reference to a TMT without establishing the transactions were attributable to that (or any) TMT. In *Copeland*, the IRS imposed §6621(c) based on Temp.Treas.Reg. §301.6621-2T, A-4(1), which defines as a TMT, "[a]ny deduction disallowed for any period under section 183, relating to an activity engaged in by an individual or an S corporation that is not engaged in for profit ...." The Fifth Circuit found the Tax Court used the §183 profit motive factors to hold the deductions were disallowed under §§162 and 174. Disallowances under §§162 and 174 are not TMTs and §183 does not apply to partnerships.[64]

If "sham" was the intended ground for adjustment in the TFV Decision, the TMP

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[64] *Copeland*, 290 F.3d at 333-7.

would have agreed to the word "sham." Instead, the decision referred to "lack of economic substance," as that term applies as one element of "sham."

In *Battelstein* the Fifth Circuit disallowed deductions despite acknowledging the taxpayer's *bona fide* business purpose. Similarly, in *Weiner*, "lack of economic substance" was not addressed and §6621(c) was, nonetheless, held inapplicable.[65] This is analogous to the "lack of economic substance" determination of the TFV Decision.

The converse occurred in *Copeland*. There the court upheld disallowance of the deductions due to lack of the managing partner's profit motive. The Fifth Circuit ordered refund of the penalty interest because lack of profit motive alone is not a TMT. These cases demonstrate the difference between "sham" and its individual constituent elements.

The issue of whether §6621(c) sham requires some profit motive determination and whether it is made at the partner or partnership-level has festered for years. At

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[65] *Weiner v. U.S.*, 255 F.Supp.2d 673, 682 (S.D. Tex. 2002).

oral argument the Fifth Circuit panel recognized the ambiguity surrounding the sham transaction doctrine.[66] *Duffie* recognized the Fifth Circuit had not previously clearly resolved whether lack of economic substance alone establishes sham or if a profit motive determination is required.

*Duffie* held the partner's profit motive is unnecessary to establish sham but did not address whether a partnership-level lack of profit motive or business purpose is

necessary to establish sham. There was no such TFV determination that could elevate lack of economic substance to sham. That absence should have compelled reversal and judgment for the Duffies, even if the irrelevancy of John Duffie's profit motive had been sustained. If that omission implies a partnership-level profit motive is irrelevant, then *Duffie* conflicts with *Frank Lyon* and the many authorities that make a profit motive inquiry.

The Fifth Circuit has issued the only direct

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[66] March 2, 2010 oral argument available at http://www.ca5.uscourts.gov/OralArgRecordings/08/08-20708_3-2-2010.wma.

precedent on this point.[67] In *Lukens*, *Durrett*, and *Chamberlain*, at least one issue on appeal was imposition of §6621(c) penalty interest against individual partners following Tax Court proceedings. The IRS assessed §6621(c) interest on the basis that the partnership transactions were shams. The partners challenged the §6621(c) assessment, asserting it was necessary to determine their individual profit motives before that enhanced interest could be imposed. The Fifth Circuit acknowledged that a separate, partner-level, profit motive determination was necessary to impose §6621(c), even though the Tax Court had determined that the partnership transactions lacked economic substance. As the Court succinctly noted in *Chamberlain*: "In determining a profit motive we focus on the intent of the taxpayer, not that of the underlying entity or activity."[68] *Lukens*, *Durrett*, and *Chamberlain* make clear that §6621(c) sham considers profit motive at the partner-level. *Duffie* directly conflicts and

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[67] *Lukens*, 945 F.2d at 99; *Durrett v. U.S.*, 71 F.3d 515 (5th Cir. 1996); *Chamberlain v. U.S.*, 66 F.3d 729, n.13 (5th Cir. 1995).

[68] *Chamberlain*, at n. 13, *citing Lukens*, 945 F.2d at 99.

cannot be reconciled.

The limited "economic substance" finding in the TFV Decision and the reference to "§6621(c)(3)(A)(v)" makes very good sense if the parties were contemplating the *Luken*, *Durrett* and *Chamberlain* precedent, recognizing that the partnership level prong or element of §6621(c) must be determined at the TEFRA partnership level in order to impose §6621(c) if lack of profit motive was then determined at the partner level – an issue the Government pursued and lost in the trial court in *Weiner*.[69] The TMP was aware of the *Weiner* litigation at the time the TFV Decision was negotiated and entered.

By adopting the trial court's *Duffie* opinion verbatim, the Fifth Circuit again left the sham definition unresolved. The Duffies ask this Court for a definitive definition of sham, at least for §6621(c), establishing whether any profit motive determination is required to impose §6621(c) based on sham and whether at the partnership or the partner level.

Finally, §6621(c)(3)(A)(v) was added by amendment to §6621(c) following two Tax

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[69] *Weiner*, 255 F.Supp.2d 673.

Court decisions: *Forseth* and *DeMartino*.[70] In *Forseth*, the IRS moved for leave to amend its answer to assert §6621(c) more than a year after trial and four months after post-trial briefing. Among the many alternative grounds for adjustment asserted by the IRS was that the gold and silver transactions in an alleged "principal's market" were "fictitious or preconceived shams lacking economic substance" and that the transactions were §1092(c) straddles. At the time §1092(c) straddles were listed TMTs but sham transactions were not. The Tax Court refused to reopen the case for the single purpose of establishing a basis to impose §6621(c). The court noted the anomaly that a real straddle transaction would be subject to §6621(c) but a factual sham transaction would not, the court passed resolution of the matter to Congress.[71]

*DeMartino* likewise considered the applicability of §6621(c) to prearranged oil and gas straddles. The court found the trades were not *bona fide* transactions executed in a competitive open market but that the

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[70] *Forseth v. C.I.R.*, T.C. Memo. 1985-279, 1985 WL 14906 (1985) and *DeMartino v. C.I.R.*, T.C.Memo. 1986-263, 1986 WL 22000 (1986).

[71] *Forseth*, at n. 6.

taxpayers were making prearranged trades using an organized market created specifically for ulterior purposes, *i.e.*, the transactions were shams-in-fact.[72] Like *Forseth*, *DeMarino* recognized the anomalous result of imposing §6621(c) against real straddles but not "purely fictitious" straddles, but the court was persuaded the answer was up to Congress to amend the statute. Citing *Forseth* and *DeMartino*, Congress did just that. Both related to purely fictitious transactions devoid of any profit motive or business purpose.

Section 6621(c)(3)(A)(v) was enacted to apply to purely fictitious transactions lacking any profit motive or business purpose, not to transaction like those in *Frank Lyon*, *Battelstein* or TFV where there were legitimate transactions the form of which were disregarded. Here the IRS drafted the TFV Decision allowing over half of the partnership items that were at issue, which is hardly consistent with a finding on par with fraud.

### 3. The Six Month Limitations Period Was Misapplied

The standard §6511 limitations period requires that tax refund claims be filed within

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[72] *DeMartino*, at *18-21.

the later of i) two years from the time the tax was paid, or ii) three years from the time the return was filed. Since TEFRAs inception, taxpayers have filed affected item refund claims pursuant to §6511 and the IRS has accepted those claims.[73]

In *Duffie* the Government resurrected an assertion that §6511 is not the controlling limitations period because §6230(d)(6) excepts the standard administrative procedures and limitations periods for refund claims "attributable to a partnership item (or an affected item)."[74] In *Brookstone*, as in *Duffie*, the Government asserted §6230(d)(6) excepted that affected-item claim[75] from §6511 and the §6230(c)(2)(A) 6-month limitations period for filing refund claims controlled. The *Brookstone* trial court was persuaded that the §6230(d)(6) affected item exclusion created a void in the applicable limitations period, an anomaly the court found untenable and unintended. That

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[73] *See e.g., Weiner.*

[74] The affected item reference has been deleted. P.L. 105-34, §1239(c)(1), 1997. *Brookstone Corp. v. U.S.*, 1994 WL 621576 (S.D.Tex. 1994)(unpublished), aff'd without written opinion, 58 F.3d 637 (5th Cir. 1995).

[75] The affected item at issue was the §6659 penalty.

court also rejected the Government's convenient reliance on the shortened §6230(c)(2)(A) limitations period because the claim did not meet the statutory definition for that type of claim – that the IRS "***erroneously computed*** any computational adjustment." [Emphasis added.] The *Brookstone* court rejected the Government's argument and held the claim was timely under §6511.[76] The Fifth Circuit affirmed without written opinion. The Government repeated those arguments and assertions in *Duffie*. But *Duffie* did not follow or distinguish *Brookstone*.

*Duffie* also conflicts with *McGann*, a non-AMCOR case. There the Court of Federal Claims considered the Government's same arguments that §6230(d)(6) applied and the §6230(c)(2)(A) 6-month limitations period controlled. The trial court denied the Government's motion, holding the claims were timely under §6511.

Section 6230(c)(2)(A) applies only to claims that the IRS "erroneously computed" the tax liability. *Duffie* overlooked that statutory

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[76] If §6511 does not apply either of two longer statutes would – 28 U.S.C. §2401(6 years "after the right of action first accrues;" or §§6230(d)(1), §6601(e)(1) and (g) (10 years from the date the tax is assessed).

qualifier. "Compute" means "to determine (an amount, etc.) by arithmetic."[77] "Erroneous computation" means an error in arithmetic, *i.e.* a math mistake.[78] The Duffies' claim is not that the IRS "erroneously computed" the §6621(c) interest. The IRS's mathematical calculations were not disputed. Their claim is that the IRS improperly applied the §6621(c) rate at all.[79] In *Field*, the Second Circuit acknowledged such claims "do not seek a refund based upon a computational error under §6230(c)."[80] By excluding the "erroneous computation" qualifier, *Duffie* also improperly extended the §6230(c)(2)(A) limitations period to *all* refunds of tax assessed as a computational adjustment, which include, *e.g.*, a claim based on a time barred assessment.

Additionally, the §6230(c)(2)(A) 6-month deadline technically does not apply to the

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[77] Webster's New World Dictionary and Thesaurus, p. 122, Simon & Schuster, Inc. (1996).

[78] *Kuralt v. U.S.*, 866 F.Supp. 727, 728 (S.D.N.Y., 1994) (describing §6230(c)(1)(A) claims for "mathematical error").

[79] *See Copeland*, at 332-3.

[80] *Field*, at n.2. App. 62.

Duffies' claim because the assessment was not made as a "computational adjustment," which is a statutorily defined term that refers to the mathematical application of the partnership-level adjustments to the partner's individual tax return and calculation of the partner's resulting personal tax liability.[81] Overwhelming authority holds application of the §6621(c) punitive rate is not a "computational adjustment," in part because it requires partner-level determinations that can be made only at the partner-level after the computational adjustments are made.[82] *Duffie* repeatedly iterates that the §6621(c) "attributable to a TMT" determination can be made only at the partner-level. *Weiner* recognized Treas.Reg. §301.6621-2T, A-5 determines what part is "attributable to a TMT" only *after* the computational adjustments are made.

Moreover, in *McGann* the trial court recognized the 6-month period does not begin until the IRS issues a "notice of computational adjustment." But the Tax Code does not define

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[81] §6231(a)(6). App. 249.

[82] §6230(a)(2)(A)(i), App. 246; *See N.C.F.*, 89 T.C. at 744.

that notice and the IRS has not designed such notice. *McGann* found the start date to be too indeterminate to be enforceable.[83]

*Duffie* also conflicts with *Bush*.[84] There the Government argued the determinations of taxpayers' at risk amounts were computational adjustments because "the IRS merely had to apply the terms of the Closing Agreements to [the Bushes' and Shelton's tax returns] through a computation" – the *Petaluma* and *Jade Trading* "low-hanging fruit" argument. The Government urged that so long as no individual partner-level *factual* determination are required, there is a only a computational adjustment. The Federal Circuit rejected that argument, followed the statutory definition, and found a computational adjustment exists only if the partner's individual liability changes to "properly reflect[ ] the treatment ... of a partnership item."

Moreover, *Duffie* initially recognized the claim was whether "the Tax Court determined that the adjustments to partnership expenses were attributable to tax-motivated transactions" App. 49. but then held:

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[83] *McGann*, 76 Fed.Cl. at 758-61.

[84] *Bush v. U.S.*, 599 F.3d 1352 (Fed.Cir. 2010).

> The only issue in this partner-level refund action is whether the Duffies' tax underpayment resulting from the partnership transactions previously found to be tax-motivated was substantial, $1,000 or greater, clearly a computational rather than a substantive issue.

App. 58.

*Duffie* held the erroneous re-characterization version of the claim was subject to §6230(c)(2)(A) and time barred. But the Duffies' claim did not dispute whether their underpayment was substantial. If the limitations holding has any applicability, it should be narrowly read as *dicta* applicble only to claims that challenge whether the liability is substantial (over $1,000).

Unless narrowly read, the limitations ruling renders the rest of the opinion mere *dicta* or an advisory opinion because late filing bars jurisdiction over *res judicata* and §7422(h) and the merits of the "attributable to" a TMT claim should never have been addressed.

## CONCLUSION

This Court should hear this case and resolve the uncertainty regarding TEFRA §7422(h) and §6230(c)(2)(A) affected item jurisdiction issues and render some manageable interpretation out of the morass of "economic substance" and "sham" rulings. These are all issues that will have a major impact on the tax law in the future.

Respectfully submitted.

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AUGUST 2010

## APPENDIX - Table of Contents

**Opinions Below:**

*Duffie v. U.S.*,
600 F.3d 362 (5th Cir. 2010) . . . . . App. 1

**Other Relevant Opinions:**

*Field v. U.S.*,
328 F.3d 58 (2nd Cir. 2003) . . . . . App. 60

*Frank Lyon Co. v. U.S.*,
435 U.S. 561 (1978) . . . . . App. 67

*Gregory v. Helvering*,
293 U.S. 465 (1935) . . . . . App. 105

*Jade Trading, LLC v. U.S.*,
598 F.3d 1372 (Fed.Cir. 2010) . . . . . App. 111

*Monti v. U.S.*,
223 F.3d 76 (2nd Cir. 2000) . . . . . App. 134

*Petaluma FX Partners, LLC v. C.I.R.*,
591 F.3d 649 (D.C.Cir. 2010) . . . . . App. 157

*Prochorenko v. U.S.*,
243 F.3d 1359 (Fed.Cir. 2001) . . . . . App. 175

*Schell v. U.S.*,
589 F.3d 1378 (Fed.Cir. 2009) . . . . . App. 196

*Weiner v. U.S.*,
389 F.3d 152 (5th Cir. 2004) . . . . . App. 209

**Relevant Orders:**

Order of the Fifth Circuit
Denying Rehearing *En Banc* . . . . . App. 236

**Federal Statutes**
**Effective for the Tax Years in Issue:**

26 U.S.C. (the Internal Revenue Code)


§183 . . . . . App. 238
§6216 . . . . . App. 238
§6221 . . . . . App. 238
§6223 . . . . . App. 240
§6224 . . . . . App. 240
§6225 . . . . . App. 241
§6226 . . . . . App. 242
§6228 . . . . . App. 245
§6230 . . . . . App. 246
§6231 . . . . . App. 249
§6511 . . . . . App. 250
§6621(c) . . . . . App. 251
§7422 . . . . . App. 253


**Federal Regulations**
**Effective for the Tax Years in Issue:**


Treas. Reg. §301.6221-1T . . . . . App. 254
Treas. Reg. §301.6621-2T . . . . . App. 254


**Tax Court Rules**


245 . . . . . App. 259
247 . . . . . App. 259

**Excerpts From the Record Below**

Explanation of Adjustments
Attached to 1984 TFV FPAA
Dated April 10, 1991 . . . . . App. 262

1984 and 1985 Agreed Decision
Filed July 19, 2001 in
*Texas Farm Venturers v. C.I.R.*,
Tax Court Docket No. 15058-91 . . . App. 267

# IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 08-20708.

John C. DUFFIE; Melissa Duffie

Plaintiffs-Appellants,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

Appeal from the United States District Court for the Southern District of Texas

Before KING, JOLLY and STEWART, Circuit Judges.

CARL E. STEWART, Circuit Judge:

John and Melissa Duffie appeal the district court's grant of summary judgment in their tax refund suit. We affirm.

A district court's grant of summary judgment is reviewed de novo, applying the same standard as the district court. *Kornman & Assocs. v. United States*, 527 F.3d 443, 450 (5th Cir.2008). This court

reviews findings of fact for clear error and legal issues de novo. *Houston Exploration Co. v. Halliburton Energy Servs., Inc.*, 359 F.3d 777, 779 (5th Cir.2004). Specifically, a district court's characterization of a transaction for tax purposes is a question of law subject to de novo review, but the particular facts from which that characterization is made are reviewed for clear error. *See Compaq Computer Corp. v. Comm'r*, 277 F.3d 778, 780 (5th Cir.2001) (citing *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n. 16, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978)).

We have reviewed the applicable law, the appellate briefs of the parties, the record on appeal, and the district court's opinion. We have further considered the contentions of the parties presented at oral argument. We are convinced that the district court correctly decided the issues in this appeal in its thorough and thoughtful opinion, which we attach hereto and adopt as the opinion of this court. *See Keener v. United States*, 551 F.3d 1358 (Fed.Cir.), cert. denied, --- U.S. ----, 130 S.Ct. 153, 175 L.Ed.2d 38 (2009). The judgment of the district court is therefore AFFIRMED.

# APPENDIX

## IN THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF TEXAS HOUSTON DIVISION

| | | |
|---|---|---|
| JOHN C. and MELISSA DUFFIE, | § | |
| | § | |
| Plaintiffs, | § | CIVIL ACTION |
| VS. | § | NO. H-06-2870 |
| | § | |
| UNITED STATES OF AMERICA, | § | |
| | § | |
| Defendant. | § | |

## MEMORANDUM AND OPINION

In this tax refund suit, the plaintiffs, John Duffie and Melissa Duffie, allege that the Internal Revenue Service improperly assessed enhanced or penalty interest against them under 26 U.S.C. §6621(c). That statute, which was effective for only a few years, provides for interest at 120% of the statutory interest rate when there is a substantial underpayment of taxes attributable to a tax-motivated transaction.

John Duffie became a limited partner in American Agri-Corp, Inc. ("AMCOR") in 1984. His proportionate share of the partnership's income loss was reported on the Duffies' 1984 joint income tax return. The IRS subsequently disallowed AMCOR expense deductions for t x year 1984,

reducing the partnership's loss. As a result, partners, including the Duffies, had underpaid their income tax liability for 1984. The IRS assessed enhanced interest against the Duffies under Section 6621(c) for the underpayment. The Duffies seek a refund.

The parties have filed cross-motions for summary judgment. The Duffies seek summary judgment that as a matter of law, imposing the Section 6621(c) enhanced or penalty rate of interest was erroneous because it is based on a Tax Court judgment entered after a settlement of partnership-level items that did not decide partner-level issues critical to assessing the interest. The government asserts that the Duffies' claims are barred by *res judicata* and that this court lacks subject-matter jurisdiction over the refund claim because it would require the court to reexamine the partnership items resolved in the Tax Court.

Based on a careful review of the motions, the pleadings, the record, and the applicable law, this court denies the Duffies' motion for summary judgment and grants the government's cross-motion. Final judgment dismissing this case is entered by separate order. The reasons for this ruling are set forth in detail below.

## I. Background

### A. The Tax Equity and Fiscal Responsibility Act of 1982

Partnerships file informational tax returns, but partnerships are not subject to federal income taxes. 26 U.S.C. §701. Instead, a partnership is treated as a conduit through which income passes to its partners, who are responsible for reporting their pro rata share of tax on their individual income tax returns. *Id.*

Before 1982, examining a partnership for federal tax purposes was a tedious process. A partnership filed an informational tax return on a Form 1065, which reflected the distributive shares of partnership income, gains, deductions, and credits attributable to the partners. If the IRS sought to adjust an item on a partnership return, the IRS had to examine each partner's individual return. As a result, the IRS could not ensure consistent adjustments of partnership items among partners. In response, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982, Pub.L. No. 97-248, 96 Stat. 324, 648-671 ("TEFRA").

TEFRA consolidated the partnership-level audit and adjustment procedures by requiring that "the tax treatment of any partnership item shall be determined at the partnership level." 26 U.S.C. §6221. TEFRA "created a single unified procedure for determining the tax treatment of all

partnership items at the partnership level, rather than separately at the partner level." *In re Crowell*, 305 F.3d 474, 478 (6th Cir.2002). After TEFRA, the IRS could adjust partnership items "at a singular proceeding, and then subsequently assess all of the partners based upon the adjustment to that particular item. The IRS would not have to conduct individual 'partner level' proceedings for each member of a partnership." *Prati v. United States*, 81 Fed.Cl. 422, 427 (Fed.Cl.2008).

TEFRA defines a "partnership item" as "any item required to be taken into account for the partnership's taxable year under any provision of Subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of [subtitle F], such item is more appropriately determined at the partnership level than at the partner level." 26 U.S.C. §6231(a)(3). The regulations provide that items "more appropriately determined at the partnership level" include the gains, losses, deductions, and credits of a partnership. 26 C.F.R. §301.6231(a)(3)-1. The term "partnership item" also "includes the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc." 26 C.F.R. §301.6231(a)(3)-1(b).

A "nonpartnership item" is "an item which is (or is treated as) not a partnership item." 26 U.S.C. §6231(a)(4). The tax treatment of nonpartnership items requires partner-specific determinations that

must be made at the individual partner level. *See Crnkovich v. United States*, 202 F.3d 1325, 1328-29 (Fed.Cir.2000).

TEFRA also includes a hybrid category of "affected items." An "affected item" is "any item to the extent such item is affected by a partnership item." 26 U.S.C. §6231(a)(5). For example, a taxpayer-partner's medical expense deduction under 26 U.S.C. §213(a) is an "affected item." Because a taxpayer can only deduct medical expenses to the extent those expenses exceed 7.5% of adjusted gross income, a change in the partnership's income affects the amount of the partner's deduction. Affected items can have both partnership-item and nonpartnership-item components. For example, determining a limited partner's "amount at risk" for purposes of 26 U.S.C. §465 may require a partnership-item determination of the amount of partnership debt and a nonpartnership-item determination of the amount of that debt assumed by the limited partner.

There are two different types of affected items. "The first type of affected items requires only a computational adjustment at the partner level, which can only be made at the conclusion of the partnership level proceeding." *Woody v. Comm'r of Internal Revenue*, 95 T.C. 193, 201-02, 1990 WL 121140 (1990) (citing *N.C.F. Energy Partners v. Comm'r of Internal Revenue*, 89 T.C. 741, 744, 1987 WL 45298 (1987)). "The term 'computational

adjustment' means the change in the tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item." 26 U.S.C. §6231(a)(6). "A computational adjustment may include a change in tax liability that reflects a change in an affected item where that change is necessary to properly reflect the treatment of a partnership item." 26 C.F.R. §301.6231(a)(6)-1T(a). Such a "computational affected item" may be applied to the individual partner without any factual determination at the partner level. "The other type of affected item is one that is dependent upon factual determinations (other than a computation) relating to an adjustment made at the partner level." *Woody*, 95 T.C. at 202; *N.C.F. Energy Partners*, 89 T.C. at 744-75. These affected items require fact-finding particular to the individual partner.

If the IRS decides to adjust any partnership items on a partnership's informational income tax return, it must notify the individual partners of the adjustment by issuing a Notice of Final Partnership Administrative Adjustment ("FPAA"). 26 U.S.C. §6223; *see also Kaplan v. United States*, 133 F.3d 469, 471 (7th Cir.1998). A Notice of FPAA sets out the proposed adjustments, e.g. disallowing all or part of partnership's deductions, and lists the grounds for the adjustments. *Id.* For ninety days after a Notice of FPAA issues, the Tax Matters

Partner[1] has the exclusive right to challenge the proposed adjustments in Tax Court, the Court of Federal Claims, or a United States District Court. 26 U.S.C. §6226(a). If the TMP does not file suit challenging the proposed adjustments within this period, other partners have sixty days to file a petition for readjustment. *Id. §6226*(b)(1). If a partnership level challenge is filed, each partner in the partnership is deemed a party to the case. 26 U.S.C. §6226(c)(1).

If a partner settles his tax liability with the IRS, the partner will not be able to participate in the partnership-level suit and will be bound by the settlement agreement terms. *Id. §6228*(a)(4), §6226(c)(1). If the IRS enters into a settlement agreement with any partner with respect to partnership items, other partners are entitled to a consistent settlement as to those partnership items. 26 U.S.C. §6224(c)(2). The TMP may bind "non-notice" partners to a settlement agreement resolving partnership items if the TMP expressly states in the agreement that it "shall bind the other partners." 26 U.S.C. §6224(c)(3)(A). A non-notice partner is a partner with less than a 1% interest in a partnership that has more than 100 partners. *See* 26 U.S.C. §§6231(a)(8), 6223(b)(1).

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[1] A tax matters partner is the partner designated to act as a liaison between the partnership and the IRS in administrative proceedings and as the representative of the partnership in judicial proceedings.

In a partnership-level proceeding, the Tax Court has jurisdiction to determine all partnership items for the tax year to which the FPAA relates. The Tax Court also has jurisdiction to determinate the proper allocation of the partnership items among the partners. 26 U.S.C. §6226(f). For tax years before1997, the Tax Court does not have jurisdiction over nonpartnership items or over affected items.[2] Id. The TMP and the IRS may reach an agreed decision in the Tax Court as to partnership items. TAX COURT R. 248(b). In a partner-level refund action, courts do not have jurisdiction over partnership items. 26 U.S.C. §7422(h). But a court does have jurisdiction in a partner-level refund action over partnership items that were converted to nonpartnership items through a settlement with the IRS. *Id.* §6231(b)(1)(C).

**B. Factual Background**

In the early 1980s, AMCOR organized a number of limited partnerships for which it acted as general partner. These partnerships had as stated goals acquiring agricultural land, investing in

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[2] Congress amended Section 6226(f) in 1997 to grant the Tax Court jurisdiction over "the applicability of any penalty, addition to tax, or additional amount which related to an adjustment to a partnership item." The amendment was limited to tax years ending after August 5, 1997.

agricultural ventures, and growing crops.[3] AMCOR solicited investments from high-income professionals across the country. Each partner in an AMCOR partnership would receive a projected tax loss from crops planted in the first year of roughly twice that partner's investment. Investors paid the farming expenses up front and deducted the amount invested on their tax returns. The next year, when the crops were harvested, the amount of loss in excess of the amount invested would be subject to taxes. However, the farming expenses typically exceeded any income realized from the farming activities. In 1987, the IRS began an investigation and audit into the AMCOR partnerships to determine whether they were impermissible tax shelters.

In 1984, John Duffie invested as a limited partner in one of the AMCOR partnerships, Texas Farm Venturers, a Texas limited partnership.[4] The general partners in Texas Farm Venturers in 1984 included AMCOR and Robert A. Wright. John Duffie held a 0.5966% interest in Texas Farm

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[3] In *Crop Associates-1986 v. Comm'r of Internal Revenue*, T.C. Memo 2000-216, 2000 WL 976792 (U.S. Tax Court 2000), the court found that from its inception in 1981 until 1986, AMCOR was engaged in the business of promoting tax shelter partnerships.

[4] Although Melissa Duffie was not a partner in Texas Farm Venturers, she is a party to this lawsuit because she filed joint tax returns with her husband, John Duffie. *See* 26 U.S.C. §6013(d)(3).

Venturers. On March 25, 1985, Texas Farm Venturers timely filed its partnership return for tax year 1984. (Docket Entry No. 29, Appendix at 9). The return states that Texas Farm Venturers had one hundred partners.[5] The partnership reported an ordinary income loss of $9,698,031.00 for 1984. (*Id.*). The Duffies timely filed their 1984 income tax return on June 18, 1985. (Docket Entry No. 30, Ex. 2). The Duffies' joint return reported John Duffie's share of the Texas Farm Venturers loss as $57,859.00. (Docket Entry No. 30, Ex. 1).

After investigating the AMCOR partnerships, the IRS issued a Notice of FPAA to the TMPs of a number of the AMCOR partnerships in 1990 and 1991. The notices proposed to adjust the partnership items of these AMCOR partnerships for tax years 1984, 1985, and 1986, as applicable. Wright, the TMP of Texas Farm Venturers, received a Notice of FPAA on April 10, 1991. (Docket Entry No. 30, Ex. 3). The FPAA listed several reasons for disallowing part of the Texas Farm Venturer farming expenses. The reasons included that the IRS had determined that the partnership's activities were a series of sham

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[5] Although the Duffies' summary judgment motion states that John Duffie was a non-notice partner (Docket Entry No. 30 at 17), the record, including the partnership return, shows that John Duffie was a notice partner because Texas Farm Venturers did not have more than one hundred partners.

transactions and that the activities lacked economic substance. (*Id.*).

On July 10, 1991, limited partners in Texas Farm Venturers other than the TMP filed a petition in United States Tax Court contesting the FPAA for the partnership. (Docket Entry No. 29, Appendix at 16-49). The case was assigned case number 15058-91. (*Id.* at 16.). The Duffies became parties to the Tax Court case under 26 U.S.C. §6226(c), which treats nonparticipating partners as parties to a case in which a partner challenges the FPAA. The Tax Court consolidated case number 15058-91 with six other cases involving AMCOR partnerships. Wright subsequently intervened as the Texas Farm Venturers TMP.

In 1997, while the Tax Court cases were pending, several limited partners in AMCOR partnerships settled their income tax liability with the IRS by executing Forms 870-P(AD). The IRS imposed enhanced interest under 26 U.S.C. §6621(c) against these partners for underpayment of taxes. Morris Weiner, a limited partner in several AMCOR partnerships, challenged the imposition of enhanced interest. In *Weiner v. United States*, 389 F.3d 152 (5th Cir.2004), *cert. denied*, 544 U.S. 1050, 125 S.Ct. 2312, 161 L.Ed.2d 1091 (2005), the appellate court concluded that the IRS improperly assessed enhanced interest against Weiner under Section 6621(c). Because the FPAA listed multiple independent reasons for disallowing the partnership's deductions, there was "no way to

determine, without additional superfluous litigation, whether the taxpayer's underpayment is 'attributable to' a reason that also qualifies as a tax-motivated transaction (such as a sham)." *Id.* at 162.

The Duffies did not settle with the IRS. The Duffies remained parties to the Texas Farm Venturers Tax Court case. On April 16, 2001, the IRS moved under Tax Court Rule 248(b) for entry of decisions in the AMCOR cases. (Docket Entry No. 29, Appendix at 50). The Motion for Entry of Decisions stated that the IRS and the TMPs for the AMCOR partnerships had reached "contingent agreements with respect to all of the disputed partnership items at issue in the FPAA Cases." (*Id.* at 52, ¶ 8). The agreements were contingent on the Tax Court's entry of the Decision submitted with the IRS motion. The IRS Motion for Entry of Decisions stated that all partners "in each partnership whose partnership items are to be determined in the FPAA Cases and who meet the interest requirements of I.R.C. §6226(d) are deemed parties to the partnership proceedings," would be bound by the determination of the partnership items in the applicable Decision, and would be "assessed any additional tax resulting from the adjustments contained in the Decision documents pursuant to ... I.R.C. §6225, 6230(a) and 6231(a)(6)...." (*Id.*, ¶ 9). The Motion also stated that the IRS had made "preliminary determinations as to certain affected items, including the liability of the liability of the limited partners for additions to

tax pursuant to I.R.C. §6653 and 6661, and for the assessment of interest on the deficiencies in the partners' income tax at the increased rate prescribed by former I.R.C. §6621(c); which determinations the tax matters partner and other partners are expected to dispute." (*Id.*, ¶ 16). The Motion stated that "[o]nce the Decisions ... are entered by the Court and become final, respondent will assess any deficiency in income tax due from each partner by way of computational adjustment, under I.R.C. §6231(a)(6) based upon the adjustment contained in the Decisions, ... and based upon the determination made in the Decisions, respondent will assess interest which has accrued thereon under former I.R.C. §6621(c)...." (*Id.*, ¶ 20).

On June 14, 2001, the Duffies moved in the Tax Court for leave to file a notice of election to participate out of time. (Docket Entry No. 29, Appendix at 67-69). The motion for leave stated that the Duffies did not object to entry of the proposed decision. Because entry of the agreed decisions in the Tax Court could be halted by one objecting partner from any of the partnerships, the Duffies sought to preserve their right to a consistent settlement with the IRS under Section 6224(c)(2). The right to a consistent settlement was only preserved for sixty days after issuance of the Notice of FPAA. The Tax Court denied the Duffies' motion on July 19, 2001.

The Tax Court entered its decision in the Texas Farm Venturers case on July 19, 2001. (Docket Entry No. 30, Ex. 6). The decision stated that the partnerships' claimed farming expenses would be reduced by $4,154,659.00. (*Id.*). The Tax Court's decision also stated:

> [t]hat the adjustments to partnership income and expense for the taxable year 1984 are attributable to transactions which lacked economic substance, as described in former I.R.C. §6621(c)(3)(A)(v), so as to result in a substantial distortion of income and expense, as described in I.R.C. §6621(c)(3)(A)(iv), when computed under the partnership's cash receipts and disbursements method of accounting.

(*Id.*). The contingent agreement stated that all parties' right to appeal was waived. The Duffies did not appeal the Tax Court's decision.

The adjustment to the Texas Farm Venturers partnership items-specifically, the $4,154,659.00 reduction in farming expenses-resulted in a reduction of John Duffie's share of the partnership loss. This increased the Duffies' taxable income for 1984 by $27,787.000, resulting in $8,540.00 in unpaid income tax liability. On December 19, 2001, the Duffies paid the IRS an advance remittance of $44,000.00. On July 19, 2002, the IRS sent the Duffies a letter with an enclosed form, Form 4549A, that showed the adjustments to the Duffies' 1984 income tax liability as a result of the Tax

Court's decision. (Docket Entry No. 30, Ex. 10). On August 12, 2002, the IRS assessed $8,540.00 in income tax liability and $43,991.34 in interest against the Duffies for tax year 1984. (Docket Entry No. 29, Appendix at 6). This included interest at the penalty rate under Section 6621(c). The interest amount was corrected that same day to add $416.31 in interest previously allowed. (Docket Entry No. 29, Appendix at 72, 85). The Duffies' $44,000.00 advance was applied to the assessment. The IRS sent the Duffies a bill for the remaining balance of $8,947.65. The Duffies paid the IRS $8,947.65 on September 9, 2002. (*Id.*).

On August 11, 2004, the Duffies filed an amended income tax return for 1984, claiming a tax refund of $8,540.00. (Docket Entry No. 29, Appendix at 75-85). On the same day, the Duffies also filed a refund claim, IRS Form 843, for tax year 1984, requesting a refund of $43,991.34 in interest. (*Id.* at 86-95). Each document had a letter attached asserting why the Duffies were entitled to a refund. The Duffies claimed that the statute of limitations on tax year 1984 had expired before the taxes were assessed; that Section 6621(c) interest was improperly assessed; that *Avon Products, Inc. v. United States*, 588 F.2d 342 (2d Cir.1978), restricted the amount of interest that could be assessed; that interest should be abated under 26 U.S.C. §6404(e); and that a refund should be issued for the amount the Duffies would have received had the IRS not refused to compromise the Duffies' tax liability. (Docket Entry No. 29, Appendix at

79-81, 89-91). The IRS denied the Duffies' refund claims on September 8, 2004. (*Id.* at 96). The Duffies filed this lawsuit on September 8, 2006. (Docket Entry No. 1).

### C. The Summary Judgment Evidence

The relevant summary judgment evidence in the record includes the Duffies' original 1984 Income Tax Return Form 1040[6]; John Duffie's Schedule K-1 form stating his proportionate share of the Texas Farm Venturers credits and deductions[7]; the Texas Farm Venturers 1984 Form 1065[8]; the Notice of FPAA sent by the IRS to the Texas Farm Venturers TMP[9]; the Tax Court petition filed by partners of Texas Farm Venturers other than the TMP challenging the adjustments in the FPAA[10]; the IRS's Motion for Entry of Decisions in the Tax Court[11]; the Duffies' motion in the Tax Court for leave to file notice of election to

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[6] (Docket Entry No. 30, Ex. 2).

[7] (*Id.*, Ex. 1).

[8] (Docket Entry No. 29, Appendix at 9-13).

[9] (Docket Entry No. 30, Ex. 3).

[10] (Docket Entry No. 29, Appendix at 16-31).

[11] (*Id.*, Appendix at 50-66).

participate out of time[12]; the Tax Court's decision[13]; the Form 4549-A that the IRS sent to the Duffies to notify them of adjustments to their income tax liability for 1984[14]; the Duffies' amended 1984 Income Tax Return Form 1040X[15]; the Duffies' refund claim form and attached explanatory letter[16]; and the IRS letter denying the Duffies' refund claim.[17]

## II. Summary Judgment

Summary judgment is appropriate if no genuine issue of material fact exists and the moving party is entitled to judgment as a matter of law. FED.R.CIV.P. 56(c). "The movant bears the burden of identifying those portions of the record it believes demonstrate the absence of a genuine issue of material fact." *Lincoln Gen. Ins. Co. v. Reyna*, 401 F.3d 347, 349 (5th Cir.2005) (citing *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-25, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986)).

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[12] (*Id.*, Appendix at 67-69).

[13] (Docket Entry No. 30, Ex. 6).

[14] (*Id.*, Ex. 10).

[15] (Docket Entry No. 29, Appendix at 75-76).

[16] (*Id.*, Appendix at 86-91).

[17] (*Id.*, Appendix at 74).

If the burden of proof at trial lies with the nonmoving party, the movant may satisfy its initial burden by " 'showing'-that is, pointing out to the district court-that there is an absence of evidence to support the nonmoving party's case." *See Celotex*, 477 U.S. at 325, 106 S.Ct. 2548. While the party moving for summary judgment must demonstrate the absence of a genuine issue of material fact, it does not need to negate the elements of the nonmovant's case. *Boudreaux v. Swift Transp. Co.*, 402 F.3d 536, 540 (5th Cir.2005) (citation omitted). " 'An issue is material if its resolution could affect the outcome of the action.' " *DIRECTV, Inc. v. Robson*, 420 F.3d 532, 536 (5th Cir.2005) (quoting *Weeks Marine, Inc. v. Fireman's Fund Ins. Co.*, 340 F.3d 233, 235 (5th Cir.2003)). "If the moving party fails to meet its initial burden, the motion for summary judgment must be denied, regardless of the nonmovant's response." *Quorum Health Res., L.L.C. v. Maverick County Hosp. Dist.*, 308 F.3d 451, 471 (5th Cir.2002) (citing *Little v. Liquid Air Corp.*, 37 F.3d 1069, 1075 (5th Cir.1994) (en banc)).

When the moving party has met its Rule 56(c) burden, the nonmoving party cannot survive a summary judgment motion by resting on the mere allegations of its pleadings. "[T]he nonmovant must identify specific evidence in the record and articulate the manner in which that evidence supports that party's claim." *Johnson v. Deep E. Tex. Reg'l Narcotics Trafficking Task Force*, 379 F.3d 293, 301 (5th Cir.2004) (citation omitted).

"This burden is not satisfied with 'some metaphysical doubt as to the material facts,' by 'conclusory allegations,' by 'unsubstantiated assertions,' or by 'only a "scintilla" of evidence.' " *Little*, 37 F.3d at 1075 (internal citations omitted). In deciding a summary judgment motion, the court draws all reasonable inferences in the light most favorable to the nonmoving party. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 255, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986) (citation omitted).

## III. Analysis

### A. Voluntary Dismissal of the Duffies' Claims Based on the Statute of Limitations and Interest Abatement

The Duffies' complaint alleged that the IRS assessed tax and interest after the statute of limitations expired, entitling them to a refund of amounts paid under 26 U.S.C. §6401. (Docket Entry No. 1). The complaint also alleged that the IRS erroneously failed to abate interest under 26 U.S.C. §6404(e). (*Id.*). In its cross-motion for summary judgment, the government correctly noted that district courts lack jurisdiction over both of these claims. In *Weiner*, 389 F.3d at 153, the Fifth Circuit held that district courts do not have jurisdiction in a partner-level refund suit over a claim that tax and interest were assessed after the statute of limitations expired. *Id.* In *Hinck v. United States*, 550 U.S. 501, 127 S.Ct. 2011, 167 L.Ed.2d 888 (2007), the Supreme Court held that district courts lack jurisdiction to hear claims

regarding the IRS's refusal to abate interest under Section 6404(e). In their response to the cross-motion for summary judgment and reply to the response in opposition to their motion for summary judgment, the Duffies moved for voluntary dismissal of both the claims based on the statute of limitations and the claims based on interest abatement. (Docket Entry No. 35 at 1). Under FED R. CIV. P. 41(a)(2), this court grants the Duffies' motion for voluntary dismissal of both claims.

**B. Claim Preclusion**

The government argues that the Duffies' claim that the IRS improperly assessed enhanced interest under Section 6621(c) is barred by claim preclusion, or *res judicata*. The Duffies do not dispute the preclusive effect of the Tax Court's agreed decision on partnership items. Interest, including interest under Section 6621(c), is an "affected item" that has both partnership and nonpartnership components. The Duffies dispute the *res judicata* effect of the Tax Court's decision on the assessment of enhanced interest under 26 U.S.C. §6621(c).

Claim preclusion "bars the litigation of claims that either have been litigated or should have been raised in an earlier suit." *Test Masters Educ. Servs., Inc. v. Singh*, 428 F.3d 559, 571 (5th Cir.2005), *cert. denied*, 547 U.S. 1055, 126 S.Ct. 1662, 164 L.Ed.2d 397 (2006), *citing Petro-Hunt, L.L.C. v. United States*, 365 F.3d 385, 395 (5th

Cir.2004). The test for claim preclusion has four elements: (1) the parties in the subsequent action are identical to, or in privity with, the parties in the prior action; (2) the judgment in the prior case was rendered by a court of competent jurisdiction; (3) there has been a final judgment on the merits; and (4) the same claim or cause of action is involved in both suits. *Id.*; *see also Ellis v. Amex Life Ins. Co.*, 211 F.3d 935, 937 (5th Cir.2000). If a party can only win the suit by convincing the court that the prior judgment was in error, the second suit is barred. *Test Masters*, 428 F.3d at 571 (internal citations omitted). When all four elements are present, claim preclusion prohibits a litigant from asserting "any claim or defense in the later action that was or could have been raised in support of or in opposition to the cause of action asserted in the prior action." *United States v. Shanbaum*, 10 F.3d 305, 310 (5th Cir.1994).

### 1. Identical Parties in Both Actions

The first element of claim preclusion is met here because the parties in this action are identical to the parties in the Tax Court case. Under 26 U.S.C. §6226(c)(1), John Duffie was treated as a party to the Texas Farm Venturers Tax Court Case, in which the IRS was the opposing party.

### 2. Judgment Rendered by a Court of Competent Jurisdiction

The Duffies argue that the Tax Court was not a "court of competent jurisdiction" with respect to

imposing enhanced interest under Section 6621(c) on partners of the partnership. In a partnership-level proceeding, the Tax Court's jurisdiction is limited to determining partnership items and the proper allocation of those partnership items among the partners. 26 U.S.C. §6226(f). Section 6621(c), an affected item, imposes interest at 120% of the statutory rate for substantial underpayment of tax. A tax underpayment is substantial when it exceeds $1,000 for the tax year in question. 26 U.S.C. §6621(c)(2). The IRS may not assess interest under Section 6621(c) unless the substantial underpayment is attributable to one of the tax-motivated transactions defined by statute. Tax-motivated transactions include "any sham or fraudulent transaction," 26 U.S.C. §6621(c)(3)(A)(v), and any use of an accounting method that may result in a substantial distortion of income, 26 U.S.C. §6621(c)(3)(A)(iv). In the Texas Farm Venturers case, the Tax Court stated: "That the adjustments to partnership income and expense for the taxable year 1984 are attributable to transactions which lacked economic substance, as described in former I.R.C. §6621(c)(3)(A)(v) [sham transaction], so as to result in a substantial distortion of income and expense, as described in I.R.C. §6621(c)(3)(A)(iv) [accounting method] when computed under the partnership's cash receipts and disbursements method of accounting; ..." (Docket Entry No. 30, Ex. 6).

The Duffies argue that the Tax Court's determination that the partnership transactions that resulted in the adjustments "lacked economic substance, as described in former I.R.C. §6652(c)(3)(A)(v)" is not a finding of tax-motivated transactions. (Docket Entry No. 30, at 30). In other AMCOR partnership cases, courts have examined the language from the Tax Court's agreed decision in the consolidated cases and found that it clearly stated that the partnership's transactions were tax-motivated, allowing the IRS to impose interest under Section 6621(c). *See Nault v. United States*, 517 F.3d 2, 5 (1st Cir.2008); *Kimball v. Comm'r of Internal Revenue*, T.C.2008-78, 2008 WL 862339 (U.S. Tax Court 2008) (because the partnership's transactions lacked economic substance, they constituted tax motivated transactions). In *Nault*, the court stated:

> The reference to [Section 6621(c)(3)(A)(v)], which helps to define tax-motivated transactions, confirms that the transactions were "sham[s] or fraudulent transaction[s]" and therefore lacked economic substance. The phrase "so as to result in a substantial distortion of income and expense" simply tracks the language of the former 26 U.S.C. §6621(c)(3)(A)(iv), which likewise helps to define tax-motivated transactions. Thus, each phrase independently establishes that the adjustments were attributable to the partnerships' tax-motivated activities.

517 F.3d at 5 (internal citations omitted).

The government asserts that the Tax Court has already determined that the transactions that resulted in the adjustments to the partnership items were tax-motivated transactions; this determination is binding on the Duffies; and this determination meets the requirements for imposing enhanced tax under Section 6621(c), leaving open only issues that were not and could not have been addressed in the Tax Court. The open issues do not include any examination into the character of the underlying transactions. The Duffies assert that even if the Tax Court finding at the partnership level that the adjustments resulted from transactions that lacked economic substance means that they were "sham" tax-motivated transactions, this determination leaves unresolved issues requiring partner-level determinations, including the individual partner's personal profit motive. These issues were not and could not be made at the partnership level because the Tax Court does not have subject-matter jurisdiction to determine them. As a result, according to the Duffies, the Tax Court decision did not resolve their liability for the enhanced interest and they are free to challenge the assessment.

**a. The Tests for Determining Sham Transaction**

The Tax Court's jurisdiction depends on whether the test for determining a sham transaction under Section 6621(c) requires

substantive partner-level factual determinations. The genesis of the sham-transaction doctrine is the Supreme Court's decision in *Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978). The Court stated that a transaction will be accorded tax recognition only if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." *Id.* at 583-84, 98 S.Ct. 1291.

Subsequent case law developed two predominant tests for identifying a sham transaction. In *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir.1985), the Fourth Circuit adopted a two-prong standard, stating that "[t]o treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists." *Id.* at 91. The business purpose prong inquires into the taxpayer's subjective motive for entering the transaction. *Id.* at 92. The economic-substance prong "requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from the tax benefits." *Id.* at 94.

The other test, adopted by a majority of the circuits, states that "the [ ] distinct aspects of the economic sham theory inquiry do not constitute discrete prongs of a rigid two-step analysis, but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes." *ACM P'ship v. Comm'r of Internal Revenue*, 157 F.3d 231, 247 (3d Cir.1998), *cert. denied*, 526 U.S. 1017, 119 S.Ct. 1251, 143 L.Ed.2d 348 (1999); *see also Sochin v. Comm'r of Internal Revenue*, 843 F.2d 351, 354 (9th Cir.1988), *cert. denied*, 488 U.S. 824, 109 S.Ct. 72, 102 L.Ed.2d 49 (1988); *Rose v. Comm'r of Internal Revenue*, 868 F.2d 851, 854 (6th Cir.1989); *James v. Comm'r of Internal Revenue*, 899 F.2d 905, 908-09 (10th Cir.1990); *Winn-Dixie Stores, Inc. v. Comm'r of Internal Revenue*, 254 F.3d 1313, 1316 (11th Cir.2001). "The sham transaction doctrine has few bright lines, but '[i]t is clear that transactions whose sole function is to produce tax deductions are substantive shams.' " *Winn-Dixie Stores*, 254 F.3d at 1316 (quoting *Kirchman v. Comm'r of Internal Revenue*, 862 F.2d 1486, 1492 (11th Cir.1989)).

Courts of appeals following the approach followed in most of the jurisdictions to consider the issue have held that while a taxpayer's subjective business purpose or profit motive may be relevant to the sham transaction inquiry, the lack of a subjective profit motive is not required to assess interest at the enhanced rate under Section

6621(c). *See Thomas v. United States of America*, 166 F.3d 825, 833 (6th Cir.1999) ("by its plain language I.R.C. §6621(c) imposes no inquiry into the taxpayer's investment motive when the transaction is found to be a sham"); *Chakales v. Comm'r of Internal Revenue*, 79 F.3d 726, 728 (8th Cir.1996) (no basis for reading a separate state of mind requirement into the sham transaction test for purposes of Section 6621(c)(3)(A)(v)); *Estate of Carberry v. Comm'r of Internal Revenue*, 933 F.2d 1124, 1129-30 (2d Cir.1991) (upholding enhanced interest under Section 6621(c) without considering the taxpayer's motive); *Karr v. Comm'r of Internal Revenue*, 924 F.2d 1018, 1026 (11th Cir.1991) (upholding enhanced interest assessment without inquiring into taxpayer's motive because Tax Court found partnership activity lacked economic substance); *Jackson v. Comm'r of Internal Revenue*, 966 F.2d 598, 601 (10th Cir.1992) (the mere presence of a profit motive does not prevent a transaction from being a sham).

The Fifth Circuit has recognized, but not resolved, the disagreement between those circuits that apply the two-prong test for finding a sham transaction and those that collapse the prongs into a "factors" test. The Fifth Circuit has declined opportunities to determine what test should apply. In *Compaq Computer Corp. & Subsidiaries v. Comm'r of Internal Revenue*, 277 F.3d 778, 781-82 (5th Cir.2001), the court found it unnecessary to determine the appropriate standard for determining a sham transaction because in that

case, the taxpayer met its burden on both prongs. *See id.* at 781-82.[18] Because *Compaq* did not involve a partnership, "the question of how a partner's individual profit motive fits into the sham inquiry was not at issue in that case." *Weiner v. United States*, 255 F.Supp.2d 624, 657 (S.D.Tex.2002). In *Copeland v. Commissioner*, 290 F.3d 326 (5th Cir.2002), a partnership case involving a sham transaction, the Fifth Circuit did not "reach the question whether profit motive is to be tested at the individual or partnership level." *Id.* at 337. Answering this question was unnecessary in *Copeland* because the IRS relied on 26 U.S.C. §183 for disallowing the partnership's deductions, a section not applicable to partnerships. *Id.* at 337.

**b. Jurisdiction to Determine a Sham Transaction**

The Tax Court has held that it does not have jurisdiction in a partnership-level proceeding to determine "whether the adjustments made on [a FPAA] are attributable to a tax motivated transaction pursuant to section 6621(c)." *Affiliated Equip. Leasing II v. Comm'r of Internal Revenue*, 97 T.C. 575, 576-78, 1991 WL 241149 (1991) (citing

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[18] *See also IES Industries, Inc. v. United States*, 253 F.3d 350, 353-54 (8th Cir.2001) (the court expressly declined to decide whether the two-prong test was required because the transactions at issue had both economic substance and business purpose).

*White v. Comm'r of Internal Revenue*, 95 T.C. 209, 212, 1990 WL 125093 (1990)); *see also N.C.F. Energy Partners*, 89 T.C. 741 at 744, 1987 WL 45298. This is because "section 6621(c) interest is not a 'partnership item' and is not within the Court's scope of review in a partnership level proceeding," but is rather "an affected item which requires a partner-level determination." *White*, 95 T.C. at 212 (citing *N.C.F. Energy Partners*, 89 T.C. at 745). The Second and Fourth Circuits agree that interest assessed against a partner under Section 6621(c) is not a partnership item. *Field v. United States*, 328 F.3d 58, 60 (2d Cir.2003); *Zfass v. Comm'r of Internal Revenue*, 118 F.3d 184, 192 (4th Cir.1997). In *Field*, the Second Circuit stated that enhanced interest under Section 6621(c) is an affected item that turns on factual determinations made at the partner level. 328 F.3d at 60; *see also McGann v. United States*, 76 Fed.Cl. 745, 757 (Fed.Cl.2007) (assessment of enhanced interest for "tax motivated transactions" is not a partnership item, but an affected item).

In recent cases, courts have held that the Tax Court does have jurisdiction to "make factual findings concerning whether the partnership's transactions were designed merely to secure tax benefits." *River City Ranches # 1 Ltd. v. Comm'r of Internal Revenue*, 401 F.3d 1136, 1143 (9th Cir.2005); *see also Keener v. United States*, 76 Fed.Cl. 455, 469 (2007); Prati, 81 Fed.Cl. at 439. The Ninth Circuit in *River City Ranches* did not characterize Section 6621(c) interest as a

partnership item or an affected item. The court held that "the nature of the partnership's transactions (i.e., whether the transactions were tax-motivated) is a 'partnership item.'" 401 F.3d at 1143. The Tax Code defines partnership item as "any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of [subtitle F], such item is more appropriately determined at the partnership level than at the partner level." 26 U.S.C. §6231(a)(3). The court in *River City Ranches* reasoned:

> The character of the partnership's transactions does relate back to subtitle A, because it determines the individual partners' personal income taxes-a subtitle A matter. A partnership's tax items affect not the (non-existent) income tax of the partnerships, but the income tax of the partners. A partnership's tax items, which determine the partner's taxes, are litigated in partnership proceedings-not in the individual partner's cases.

*Id.* at 1144 (internal citations omitted). These cases recognize that a determination of sham transaction, properly made at the partnership level, affects the individual partner's income tax liability at the partner level.

In *Keener*, the court concluded that Section 6621(c) interest is an affected item with a

partnership-item component and a nonpartnership-item component. 76 Fed.Cl. at 469. The nature of a partnership's transactions-whether they are a sham-is the partnership item component of assessing Section 6621(c) interest. *Id.* Whether a transaction "was a sham must be resolved first in a partnership-level proceeding, before any consideration can be given in a refund action to whether the interest should have been imposed on the individual partner." *Id.*

Section 6621(c) applies to tax-motivated transactions other than sham transactions, including "any loss disallowed by reason of Section 465(a)." 26 U.S.C. §6621(c)(3)(ii). Section 465 was added to the Tax Code to combat tax shelters caused by nonrecourse financing and other situations in which taxpayers were effectively immunized from loss. *See Comm'r of Internal Revenue v. Tufts*, 461 U.S. 300, 309 n. 7, 103 S.Ct. 1826, 75 L.Ed.2d 863 (1983). Under Section 465(a), any loss from an activity covered by the section "shall be allowed only to the extent ... the taxpayer is at risk." 26 U.S.C. §465(a)(1). A taxpayer is considered to be at risk for the amount of cash contributed and for certain amounts borrowed for the activity. *Id. §465*(b). A taxpayer is generally not at risk for "amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." *Id. §465*(b)(4).

The *Keener* court drew a parallel between a sham transaction and Section 465(a). Application of the at-risk provisions of Section 465(a) is an affected item. *See Ginsburg v. Comm'r of Internal Revenue*, 127 T.C. 75, 2006 WL 2506573 (2006); *Greenberg Bros P'ship # 4 v. Comm'r of Internal Revenue*, 111 T.C. 198, 202, (1998). Issues concerning items such as the nonrecourse character of partnership notes "are to be resolved in a partnership-level proceeding, with those determinations then being binding on the partners in any refund litigation that would ensue." *Keener*, 76 Fed.Cl. at 467 (citing *Greenberg Bros. P'ship*, 111 T.C. at 202). The sham-transaction determination is appropriately made at the partnership level, in a unified proceeding, and not at the individual-partner level.

In *Keener* and *River City Ranches*, the courts distinguished between the actual assessment of interest under Section 6621(c) by the IRS, which requires that the partner's tax underpayment was greater than $1,000, and the factual determination of whether a partnership was engaged in sham transactions. The decisions characterizing Section 6621(c) interest as an "affected item" that must be resolved at the partner level did not consider whether Section 6621(c) has a partnership-item component that requires findings at the partnership level. The court in Keener stated that these cases "go astray ... in assuming that because interest is not itself a partnership item, a court is not required to resolve issues concerning the

nature of the partnership's transactions in a unified partnership proceeding." *Id.*

In *Ertz v. Comm'r of Internal Revenue*, 2007 WL 174133 (U.S. Tax Court Jan. 24, 2007), the Tax Court applied *River City Ranches* to hold that it lacked jurisdiction in a partner-level proceeding to determine whether a transaction was tax-motivated under Section 6621(c). The taxpayer-partner in Ertz resided in Idaho and the appeal from the Tax Court's decision was to the Ninth Circuit. The Tax Court followed the rule that it is bound "to follow a Court of Appeals decision which is squarely [on] point where appeal from [the] decision lies to that Court of Appeals and that court alone." *Golsen v. Comm'r of Internal Revenue*, 54 T.C. 742, 756, 1970 WL 2191 (1970), aff'd 445 F.2d 985 (10th Cir.1971), *cert. denied*, 404 U.S. 940, 92 S.Ct. 284, 30 L.Ed.2d 254 (1971). Under the Ninth Circuit precedent, the Tax Court held that jurisdiction to determine whether a transaction was tax-motivated under Section 6621(c) was only present in a partnership-level proceeding.

The *River City Ranches* rule regarding Tax Court jurisdiction is consistent with the Ninth Circuit's approach to sham transaction in the partnership context. "The determination of an existing profit motive is made at the partnership level and does not address the subjective intent of the particular partner in question." *Hill v. Commissioner*, 204 F.3d 1214, 1218 (9th Cir.2000).

Upon finding that a partnership transaction was a sham, as long as the partner's underpayment was $1,000 or greater, the IRS may impose interest under Section 6621(c) irrespective of the taxpayer-partner's subjective intent. *See id.* at 1220.

The Duffies argue that in the Fifth Circuit, a sham-transaction determination requires a finding that the individual partner lacked a profit motive. In partnership cases decided before *Compaq* and *Copeland*, the Fifth Circuit affirmed Tax Court decisions that the IRS properly imposed interest at the Section 6621(c) enhanced rate. *See Chamberlain v. Comm'r of Internal Revenue*, 66 F.3d 729, 732 (5th Cir.1995); *Lukens v. Comm'r of Internal Revenue*, 945 F.2d 92 (5th Cir.1991); *Durrett v. Comm'r of Internal Revenue*, 71 F.3d 515 (5th Cir.1996). In these cases, the Tax Court had found that the individual partner lacked a profit motive, despite testimony to the contrary. *Chamberlain*, 66 F.3d at 732; *Lukens*, 945 F.2d at 99-100; *Durrett*, 71 F.3d at 517. The Fifth Circuit affirmed the imposition of interest at the Section 6621(c) rate in these cases because the Tax Court's factual finding that the individual partners lacked a profit motive was not clearly erroneous.

The Fifth Circuit has not decided which of the two tests followed in the circuit courts is the appropriate test for sham transaction. *Copeland*, 290 F.3d at 337-38. In *Transcapital Leasing Associates 1990-II LP v. United States*, 246

Fed.Appx. 266 (5th Cir.2007), the court stated it was "unnecessary to adopt either variant of the sham transaction doctrine" "because the transaction lacked a genuine business purpose and was economically insubstantial." The court also expressed "no opinion on whether the [profit motive] analysis of an alleged sham transaction ... focuses on the subjective motivation of the taxpayer partner or the flow-through partnership entity." *Id.* In *Chamberlain*, *Lukens*, and *Durrett*, the Fifth Circuit merely affirmed the result reached in the Tax Court, based in part on the fact that the Tax Court's finding that the individuals lacked a profit motive was not clearly erroneous.

Contrary to the Duffies' assertion, the Fifth Circuit does not require a finding that an individual partner lacked a profit motive to impose interest at the enhanced rate under Section 6621(c). While the individual taxpayer's subjective business purpose or profit motive may be relevant to the sham-transaction inquiry, lack of profit motive is not required to impose interest at the enhanced rate. *See Thomas*, 166 F.3d at 833; *Karr*, 924 F.2d at 1026; *see also Cherin v. Commissioner*, 89 T.C. 986, 993, 1987 WL 45771 (1987) (the Tax Court has "never held that the mere presence of an individual's profit objective will require [it] to recognize for tax purposes a transaction which lacks economic substance"); *Bohrer v. Commissioner*, 945 F.2d 344, 348 n. 5 (10th Cir.1991) (noting that either lack of profit motive or lack of economic substance can render a

transaction a sham). In weighing the relevant factors to determine whether a partnership transaction is a sham-economic substance and business purpose-a court is not required to determine whether the individual partner lacked a profit motive in deciding that enhanced interest applies.

The Duffies concede that under Tax Court Rule 248(b) and the language of the IRS's Motion for Entry of Decisions, they are bound by the Tax Court's determination of partnership items. In its Motion for Entry of Decisions, the IRS took the position that enhanced interest under Section 6621(c) was an affected item, not a partnership item, which is a judicial admission binding on the IRS. *See Martinez v. Bally's La., Inc.*, 244 F.3d 474, 476 (5th Cir.2001) (holding "[a] judicial admission is a formal concession in the pleadings or stipulations by a party or counsel that is binding on the party making them.").

Although enhanced interest under Section 6621(c) is an affected item, it has a partnership item component and a nonpartnership-item component. *Keener*, 76 Fed. Cl at 469. The nonpartnership-item component of Section 6621(c) interest is whether the taxpayer's underpayment was substantial-$1,000 or greater-and whether it was attributable to a transaction previously determined at the partnership level to be tax-motivated. The Tax Court does not have jurisdiction to make this nonpartnership

determination in a partnership-level proceeding. The Tax Court did not determine whether any underpayment by the Duffies was substantial or whether such underpayment was attributable to Texas Farm Venturers's disallowed farming expenses. The Tax Court did determine-and had jurisdiction to do so-that the partnership's transactions resulting in the adjustments were a sham. This determination of the partnership-item component of Section 6621(c) interest is properly made at the partnership level.

Making the sham-transaction determination at the partner level could lead to inconsistent results. TEFRA was intended to channel partnership items into a unified procedure for resolution; determining whether the partnership's activities were sham transactions in a partnership-level proceeding is consistent with that purpose. The Tax Court had jurisdiction to determine whether the Texas Farm Venturers transactions were sham transactions.

### 3. Final Judgment on the Merits

Section 6226(g) states that a determination by a court on the FPAA "shall have the force and effect of a decision of the Tax Court." 26 U.S.C. §6226(g). The Duffies assert that because the Tax Court decision was an agreed decision, drafted by the IRS, it should not be given preclusive effect. The Fifth Circuit has held that an agreed decision in the Tax Court may be given res judicata effect. *Shanbaum*, 10 F.3d at 313-14. The court in *Shanbaum* stated that "[s]imply because the Tax

Court decisions were reached by agreement does not mean that [the taxpayer's] income tax and transferee liabilities were not resolved by a[sic] final judgments on the merits for the purposes of res judicata." *Id.*

Because an agreed decision is contractual in nature, the "preclusive effects should be measured by the intent of the parties." 18A WRIGHT, MILLER & COOPER, FEDERAL PRACTICE AND PROCEDURE: JURISDICTION 2D §4443. Preclusion should be denied as to claims the parties intended to leave open for further litigation. *See id.* The Duffies argue that the parties did not intend the Tax Court proceedings and decision to determine whether the assessment of Section 6621(c) interest at the partner level was appropriate. The Duffies argue that they are not bound by the agreement in Attachment C to the IRS's Motion for Entry of Decisions, which stated that the limited partners would be estopped from challenging the assessment of interest under Section 6621(c). (Docket Entry No. 29, Appendix at 63).

Once a partnership-level suit is filed in the Tax Court, the TMP may enter into a settlement agreement with the IRS that is binding on all the other partners, notice and non notice, with respect to the determination of the partnership items in dispute. TAX COURT 4. 248(b)(1)(B), 251. The agreement between the IRS and the TMP concerning Section 6621(c) interest, Attachment C, stated in relevant part:

Effective upon entry of the Decision and in consideration of the reduced adjustments set forth therein, the partners expressly consent to the assessment of interest on the deficiencies in income tax, if any, which are attributable to the adjustments to the partnership items of the partnership at the increased rate specified in former I.R.C. §6621(c).

....

Absent a timely objection to the entry of decisions ... the parties to the proceedings shall be presumed to have consented to all of the terms of the agreement described above and shall be estopped from challenging the adjustments to the partnership items determined in the decision and from challenging the assessment of interest accruing on any deficiencies in income tax attributable thereto at the increased rate prescribed by former I.R.C. §6621(c).

(*Id.* at 59-63).[19] The IRS's Motion for Entry of Decisions stated:

> [The IRS has made] preliminary determinations as to certain affected items, including the ... assessment of interest on the deficiencies in the partners' income tax at the increased rate prescribed by the

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[19] Attachment C also stated that the general partners of Texas Farm Venturers consented to the assessment of an addition to tax under 26 U.S.C. §6661 at the rate of 10% of any additional tax deficiency resulting from the adjustments to partnership items in the Tax Court decision. The time period for making this assessment began on the date the separate "Closing Agreement" between the IRS and the general partners of AMCOR partnerships became effective. The Closing Agreement between the IRS and the general partners of Texas Farm Venturers, Robert A. Wright and Frederick Behrens, repeats the general partners' consent to assessment of an addition to tax under Section 6661 as stated in Attachment C. (Docket Entry No. 30, Ex. 8). The Closing Agreement also stated that Wright and Behrens individually consented to the assessment of interest at the rate prescribed by Section 6621(c) for Wright's and Behren's tax underpayments.

In assessing interest against the Duffies under Section 6621(c), the IRS did not rely on the Closing Agreement, which only binds the general partners of Texas Farm Venturers, but rather on Attachment C, which binds the partners to the determination of partnership items in the Tax Court. Because the Tax Court's determination that Texas Farm Venturers's activities were sham transactions is a partnership item, the Duffies' argument that they are not bound by the Closing Agreement is irrelevant.

> former I.R.C. §6621(c); which determinations the tax matters partner and other partners are expected to dispute.

(Docket Entry No. 29, Appendix at 54, ¶ 16).

The agreement and decision are binding and preclude relitigation of partnership items. This includes the partnership-item component of Section 6621(c), whether the partnership's transaction resulting in the adjustments was a sham transaction. Although the IRS's Motion for Entry of Decisions states that the assessment of Section 6621(c) interest would not be subject to challenge by partners, the Motion also states that the IRS expected the partners to dispute the IRS's preliminary determinations as to the liability of the limited partners for additions to tax under Sections 6653 and 6661 and for the assessment of interest on the deficiencies in the partners' income tax at the rate set under Section 6621(c). (Docket Entry No. 29, Appendix at 54, ¶ 16). Taken together, these two sections of the Motion, the agreement, and the decision allow a partner-level challenge of the nonpartnership-item component of Section 6621(c) interest: whether the partner's underpayment was greater than $1,000 and whether it was attributable to the transaction previously determined at the partnership level to be tax-motivated.

Section 6621(c), Section 6653, and Section 6661(a), under which the IRS made determinations it expected the partners to dispute, all impose

additional tax or interest for tax underpayment. Section 6653 imposes an addition to tax of "50 percent of the interest payable under Section 6601" for an underpayment "which is attributable to ... negligence or intentional disregard" of rules or regulations. 26 U.S.C. §6653(a)(2). Section 6661(a), in effect during tax years 1983 and 1984[20], provided that if there were a "substantial understatement" of income tax for a taxable year, a penalty of twenty-five percent of the amount of the underpayment attributable to the understatement would be imposed. An understatement was deemed substantial if it exceeded the greater of ten percent of the tax required to be shown on the return or $5,000. 26 U.S.C. §6661(b).

It is instructive to look at the difference between Section 6621(c), on the one hand, and Sections 6653 and 6661, on the other, regarding the necessary factual findings at the partner level. Section 6653 requires a finding of the individual partner's negligence. *N.C.F. Energy Partners*, 89 T.C. at 744. If the transaction is a tax shelter, Section 6661 requires a partner-level factual finding concerning the taxpayer's reasonable beliefs about litigation risks. *Id.* In contrast, if the partnership-level proceeding results in adjustments attributable to a tax-motivated

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[20] This provision was repealed in 1989. *See* Omnibus Budge Reconciliation Act of 1989, Pub.L. No. 101-239, §7721(c)(2), 103 Stat. 2399.

transaction, the factual finding at the partner level for Section 6621(c) is computational. The Tax Court has held that "Section 6621(c)'s applicability ... turns on the amount of the taxpayer's underpayment attributable to a taxmotivated transaction." *N.C.F. Energy Partners*, 89 T.C. at 746. Determining the amount of a partner's underpayment resulting from the partnership-level adjustment resulting from a tax-motivated transaction is a computational task of deciding whether the underpayment amount was greater than $1,000. Although some federal district courts in the Fifth Circuit have concluded that sham transaction requires an inquiry into the individual partner's profit motive[21], the Fifth Circuit has not adopted this requirement. When a sham transaction is found at the partnership level, the factual finding required at the individual partner level is computational: whether the resulting underpayment was greater than $1,000.

The agreement in Attachment C states that "in consideration of the parties' consent to the assessment of interest at the rate prescribed by former I.R.C. §6621(c), [the IRS] expressly waives all claims against the limited partners for any additions to tax that might be due under I.R.C.

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[21] *See Weiner*, 255 F.Supp.2d at 656-57; *Kraemer v. United States*, 2002 WL 575791 (S.D.Tex. Feb.13, 2002); *Mellina v. United States*, 518 F.Supp.2d 825 (N.D.Tex.2007); *Bartimmo v. United States*, 525 F.Supp.2d 879 (S.D.Tex.2007).

§§6653 and 6661." (Docket Entry No. 29, Appendix at 62). However, the "general partners ... consent[ed] to the assessment of an addition to tax pursuant to I.R.C. §6661, at the rate of 10% of any additional tax deficiency which results from the adjustments to partnership items contained in the Decisions." (*Id.*). The IRS waived its claims against the general partners for the assessment of additional tax under Section 6653. (*Id.* at 63). When the IRS stated that it expected the partners to dispute its determinations under Sections 6653, 6661, and 6621(c), it expected that the general partners would dispute their reasonable belief about litigation risks under Section 6661 and that the limited partners would dispute the determination that their underpayments were greater than $1,000 under Section 6621(c) and whether that partner's underpayment resulted from the transaction previously determined at the partnership level to be tax-motivated. But nothing in the Motion or agreement allows a partner to relitigate the Tax Court's decision on the partnership-item components of Section 6621(c) interest. A partner may not relitigate the Tax Court's determination that the partnership transactions resulting in the adjustments were factual or economic shams, that is, tax-motivated transactions as defined in Section 6621(c).

An agreed decision in the Tax Court is generally treated as a final judgment on the merits, but its preclusive effect is limited to the items the parties agreed would be determined as a final matter, not

subject to later dispute. Claim and issue preclusion cannot be applied against a party that did not have the opportunity to litigate the matters as to which preclusion is sought. *Kremer v. Chemical Constr. Corp.*, 456 U.S. 461, 480-81 n. 22, 102 S.Ct. 1883, 72 L.Ed.2d 262 (1982). Under the IRS's Motion for Entry of Decisions, the parties did not intend to determine all aspects of the assessment of interest under Section 6621(c) as to an individual partner. The interest assessment is subject to later dispute at the partner level, but only as to the nonpartnership-item components of that assessment. The parties did intend the agreed decision to be a final judgment on the merits as to all partnership items, including the determination that the Texas Farm Venturers transactions that resulted in the adjustments were sham transactions. The Duffies may not dispute or relitigate the determinations made in the Tax Court as to the partnership-item components of the Section 6621(c) interest assessment. The Duffies may dispute and litigate in a partner-level proceeding the nonpartnership-item components of Section 6621(c) interest: whether their underpayment was substantial and whether it was attributable to the transaction previously determined to be tax motivated. The Duffies are free to challenge at the partner level the IRS's computation that their underpayment resulting from the adjustments to Texas Farm Venturers's farming expenses was greater than $1,000.

### 4. Same Claim or Cause of Action Involved in Both Suits

The fourth element of *res judicata* is met because "one's total income tax liability for each taxable year constitutes a single, unified cause of action, regardless of the variety of contested issues and points that may bear on the final computation." *Finley v. United States*, 612 F.2d 166, 170 (5th Cir.1980).

## C. Jurisdiction

The government claims that this court lacks subject-matter jurisdiction over the Duffies' refund claim because "[n]o action may be brought for a refund attributable to partnership items." 26 U.S.C. §7422(h). The Duffies argue that Section 7422(h) does not defeat this court's subject-matter jurisdiction because the assessment of interest under Section 6621(c) is an affected item, not a partnership item. The government concedes that Section 6621(c) interest is an affected item but asserts that to decide the Duffies' claim, this court would have to revisit the Tax Court's determination of the character of the partnership-item adjustments, which is the partnership prong of Section 6621(c).

The government also argues that this court lacks subject-matter jurisdiction over the Duffies' claim because they failed to file a refund claim with the IRS within the six-month TEFRA limitations period. The Duffies assert that the

six-month filing requirement does not apply to this refund claim.

### 1. Section 7422(h) is a Bar to Jurisdiction

The government argues that this court lacks jurisdiction, under Section 7422(h), to consider the Duffies' claim that the IRS erred in assessing Section 6621(c) interest against them. The government asserts that there are two parts to the determination that Section 6621(c) interest applies: (1) the adjustments to the partnership's income, losses, deductions, or credits must cause the partners' underpayment to exceed $1,000; and (2) the adjustments must be attributable to a tax-motivated transaction. 26 U.S.C. §6621(c)(2). The government argues that determining the Duffies' claim would require this court to examine partnership items, such as the adjustments to the partnerships expenses, over which this court lacks subject-matter jurisdiction.

The Duffies do not challenge the adjustments to the partnership's farming expenses that are part of the Tax Court agreed judgment. The Duffies agree that this court cannot redetermine whether the Texas Farm Venturers farming expenses lacked economic substance. The Duffies challenge the Tax Court's determination that Texas Farm Venturer's transactions were tax-motivated sham transactions.

The government cites *Keener*, 76 Fed.Cl. at 469, in which the plaintiff was a limited partner in an AMCOR partnership who sued for a refund of interest assessed under Section 6621(c). The court held that it lacked jurisdiction to consider the plaintiff's refund claim because that would require the court to decide whether it was proper to adjust partnership items, including income and expenses. Determining whether the plaintiff, a limited partner, was entitled to an interest refund would require the court to determine whether the interest was on adjustments "attributable to" the partnership-item component of Section 6621(c). The court concluded that it lacked jurisdiction to do so. *Id.*

The Duffies assert that Section 7422(h) is no bar to subject-matter jurisdiction because the IRS's interest assessment under Section 6621(c) is an affected item, not a partnership item. In *Field*, the court held that Section 7422(h) does not bar a district court from reviewing the plaintiff's claim for refund of interest assessed under Section 6621(c) because the refund claim was not "attributable to a partnership item." 329 F.3d at 59. The court stated that to be attributable to a partnership item, the refund claim must be based on the assessment of a partnership item, and the assessment of interest on a partner under Section 6621(c) is an affected item, not a partnership item. *Id.* The court's holding was based in part on the statutory definition of "partnership item," which refers to the regulations for examples of

partnership items. *See* 26 C.F.R. §301.6231(a)(3)-1. Because Section 6621(c) interest is not found in the regulation, the court held that the assessment of Section 6621(c) is not a partnership item, but an affected item. *Id.*; *see also Mellina v. United States*, 518 F.Supp.2d 825, 828-29 (N.D.Tex.2007); McGann, 76 Fed.Cl. at 757.

The Duffies' refund claim is attributable to the Tax Court's determination that the Texas Farm Venturers activities were sham transactions. The Duffies' claim is that the Tax Court's determination of sham transaction was insufficient because there was no finding that John Duffie lacked a profit motive. Because the nature of a partnership's activities-whether they are sham transactions-is the partnership-item component of an affected item, the Duffies' refund claim is based on the determination of a partnership item. Section 7422(h) deprives this court of subject-matter jurisdiction to consider the Duffies' claim that the Tax Court erred in determining that the Texas Farm Venturers activities were tax motivated sham transactions.

The Duffies also argue that Section 7422(h) does not bar jurisdiction because the partnership items at issue converted to nonpartnership items under the settlement agreement with the IRS. When a partner enters into a settlement agreement with the IRS concerning partnership items, these items are converted to nonpartnership items. 26 U.S.C. §6231(b)(1)(C). A partner who has settled with the

IRS no longer has an interest in the partnership-level proceeding. 26 U.S.C. §6226(d)(1)(A). Any determination made at the partnership level will not apply to the settling partner. The conversion from partnership items to nonpartnership items lifts the jurisdictional bar of Section 7422(h). *Alexander v. United States*, 44 F.3d 328, 331 (5th Cir.1995).

The Duffies' position is unpersuasive. The agreement on which the Tax Court decision was based expressly states that it "does not act to convert partnership items to nonpartnership items, but rather, sets forth how the Decisions will be entered by the Tax Court which will be binding on the nonparticipating partners who are parties to these proceedings." (Docket Entry No. 30, Appendix at 55). The Duffies' argument also ignores the statutory purpose and structure. TEFRA's goal of uniformity is accomplished by channeling challenges to the adjustment of partnership items into a single, unified proceeding. This goal would be undermined if a partner who participated in such a proceeding was able subsequently to challenge the partnership-level adjustments made in that proceeding in an individual refund action based on a "conversion." The rule of conversion applies only to settlement agreements entered into before the partnership-level proceedings occur, not a contingent agreement that served as the basis for an agreed decision in a partnership-level proceeding in the Tax Court.

### 2. The Duffies' Failure to Timely File a Refund Claim Deprives this Court of Jurisdiction

"The United States, as sovereign, is immune from suit save it consents to be sued ... and the terms of its consent to be sued in any court define that court's jurisdiction to entertain the suit." *United States v. Sherwood*, 312 U.S. 584, 586, 61 S.Ct. 767, 85 L.Ed. 1058 (1941). Under Section 1346(a)(1), district courts have original jurisdiction over:

> [a]ny civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws....

28 U.S.C. §1346(a)(1). "Because tax refund suits are actions in which the sovereign has waived its immunity and consented to be sued, statutory provisions governing such suits are strictly construed." *Alexander v. United States*, 829 F.Supp. 199, 200-01 (N.D.Tex.1993). One condition to suit against the United States is compliance with the time period within which a claim must be filed. Under 26 U.S.C. §7422(a):

> No suit or proceeding shall be maintained in any court for the recovery of any internal

> revenue tax alleged to have been erroneously or illegally assessed or collected ... *until a claim for refund or credit has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.*

(emphasis added). To overcome sovereign immunity in a tax refund action, a taxpayer must file a refund claim with the IRS within the time limits established by the Internal Revenue Code. *United States v. Dalm*, 494 U.S. 596, 602, 110 S.Ct. 1361, 108 L.Ed.2d 548 (1990). A taxpayer's failure to file a timely refund claim with the IRS deprives the district court of subject-matter jurisdiction. *Gustin v. United States*, 876 F.2d 485, 488 (5th Cir.1989).

The general limitations periods for filing refund claims with the IRS are prescribed by subchapter B of Chapter 66 of the Internal Revenue Code, set forth at 26 U.S.C. §6511 *et seq*. (the "regular refund procedures"). Under Section 6511(a), a refund claim must be filed within the later of two years from the time the tax was paid or three years from the time the tax return was filed. Under TEFRA, the regular refund procedures and the two or three year statutes of limitations do not apply to credit or refund of an overpayment "attributable to a

partnership item (or an affected item)." 26 U.S.C. §6230(d)(6).[22]

...The two types of affected items, computational and substantive, each have different procedural requirements. For computational affected items, the IRS need not issue a statutory notice of deficiency, and the TEFRA time requirements apply. *Woody*, 95 T.C. at 201-02. Under TEFRA, if the IRS erroneously computes the adjustment, the taxpayer must file a refund claim within six months after the IRS mails a notice of computational adjustment to the partner. 26 U.S.C. §6230(c)(2)(A). The IRS is required to follow the non-TEFRA deficiency procedures when making an adjustment relating to a non-computational or "substantive" affected item. 26 U.S.C. §6230(a)(2)(A)(I); 26 C.F.R. §301.6231(a)(6)-1T(a); *Woody*, 95 T.C. at 202; *N.C.F. Energy Partners*, 89 T.C. at 745. The TEFRA time requirements do not apply to such substantive affected items. Instead, refund claims based on substantive affected items are governed by the limitations period in Section 6511(a). *Brookstone Corp. v. United States*, 1994 WL 621576 (S.D.Tex. May 23, 1994).

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[22] Section 6230(d)(6) was subsequently amended to remove the language "(or an affected item)." Taxpayer Relief Act of 1997, Pub.L. No. 105-34, §1239(c)(1), 111 Stat. 788, 1028 (1997). The amendment was effective only as to taxable years after August 5, 1997. *Id.* at §1239(f).

The government argues that the enhanced interest assessed against the Duffies under Section 6621(c) is a computational affected item. In support, the government cites *Barlow v. Commissioner*, 78 T.C.M. (RIA) ¶ 2000-339, 2000 WL 1649506 (T.C.2000), which states that Section 6621(c) interest "is an affected item because the determination of a taxpayer's liability for such interest *may* require findings of fact peculiar to the particular taxpayer, namely the amount of the taxpayer's underpayment that is attributable to a tax motivated transaction." (emphasis added). According to the government, the fact that Section 6621(c) *may* require individual partner-level findings does not mean such findings are always required. The *Barlow* court noted that once it decides "that there is a taxmotivated transaction ..., the determination of the additional interest is largely mechanical." *Id.* at 2000-1945. Because the Tax Court judgment found that the adjustments at the partnership level resulted from transactions lacking in economic substance, the government argues that the determination of the Duffies' additional interest was similarly mechanical. The government asserts that substantive affected items "are more accurately described as affected items that depend on 'non-computational' partner level factual determinations." *Olson v. United States*, 37 Fed.Cl. 727, 732 n. 7 (1997). The factual determination at the partner level, according to the government, must be more than just computational or mechanical to be a substantive affected item.

There are no non-computational facts, the government maintains, that must be determined at the partner level to determine whether Section 6621(c) interest was properly applied to the Duffies.

In response, the Duffies assert that the assessment of Section 6621(c) interest is a substantive affected item, requiring factual determinations at the partner level. The Duffies cite *Mellina*, 518 F.Supp.2d at 829-30, and *Bartimmo*, 525 F.Supp.2d at 884. In both *Mellina* and *Bartimmo*, the courts stated that Section 6621(c) interest is an affected item that turns on issues specific to the individual partners. However, neither court analyzed or discussed what partner-specific issues had to be determined at the partner level. The *Mellina* court relied on the Second Circuit's opinion in *Field*, 328 F.3d at 59, as holding that Section 6621(c) interest is always substantive affected item and not a computational adjustment. The question before the Field court was whether Section 6621(c) is a partnership item, not whether it is a substantive or computational affected item. The statement in Field that Section 6621(c) interest is a substantive affected item comes from a parenthetical in which the court summarized the holding of *Barlow*, 78 T.C.M. at 2000339. *Barlow* clarified that the partner-specific issues with respect to Section 6621(c) interest are "the amount of the taxpayer's underpayment that is attributable to a taxmotivated transaction." *Id.* at 2000-1944.

In the Texas Farm Venturers case, the Tax Court determined that the adjustments to partnership expenses were attributable to tax-motivated transactions. The only issue in this partner-level refund action is whether the Duffies' tax underpayment resulting from the partnership transactions previously found to be tax-motivated was substantial, $1,000 or greater, clearly a computational rather than a substantive issue. In this case, the IRS's assessment of interest under Section 6621(c) is a computational affected item. Because the interest assessment under Section 6621(c) is a computational affected item in this case, the general limitations period of Section 6511(a) does not apply. Rather, the TEFRA six month statute of limitations applies to the Duffies' refund claim.

The Duffies have the burden of showing compliance with the applicable limitations period. *See Makarova v. United States*, 201 F.3d 110, 113 (2d Cir.2000). The undisputed facts in the record show that the IRS notified the Duffies of the adjustments to their income tax liability on July 19, 2002 and assessed additional tax liability and interest on August 12, 2002. The Duffies paid the full balance of tax and interest on September 9, 2002. It is undisputed that the Duffies filed a refund claim on August 11, 2004. The Duffies failed to timely file their refund claim with the IRS within the applicable six-month limitations period.

## IV. Conclusion

The Tax Court's decision is *res judicata* with respect to partnership items, including the determination that the Texas Farm Venturers transactions that resulted in the partnership adjustments were sham transactions. This court does not have subject-matter jurisdiction to review substantive issues relating to the interest assessment under Section 6621(c) because the interest assessment is attributable to a partnership item. The partnership item, the character of the transactions that resulted in the adjustments, was resolved by the Tax Court's determination that the Texas Farm Venturers transactions were sham transactions. This court also lacks subject-matter jurisdiction because the Duffies failed to timely file their refund claim with the IRS. This court denies the Duffies' motion for summary judgment and grants the government's cross-motion for summary judgment. Final judgment is entered by separate order.

SIGNED on September 30, 2008, at Houston, Texas.

/s/ Lee H. Rosenthal
Lee H. Rosenthal,
United States District Judge

**UNITED STATES COURT OF APPEALS**
**FOR THE SECOND CIRCUIT**

August Term, 2002

(Argued: April 11, 2003 Decided: May 2, 2003)

Docket No. 02-6163

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DAVID A. FIELD and ELLEN J. FIELD,

Plaintiffs-Appellants,

-v.- 02-6163

UNITED STATES OF AMERICA,

Defendant-Appellee.

----------X

Before: HON. DENNIS JACOBS,
HON. CHESTER J. STRAUB,
Circuit Judges,
HON. GREGORY W. CARMAN,
Chief Judge.[23]

Appeal from a judgment, entered in the United States District Court for the Southern District of New York (Scheindlin, J.), dismissing a complaint for lack of subject matter jurisdiction.

Vacated and remanded.

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[23] Honorable Gregory W. Carman, Chief Judge of the United States Court of International Trade, sitting by designation.

ELLIOT I. MILLER, New York, NY (David A. Field, on the brief), for Plaintiffs-Appellants David A. Field and Ellen J. Field.

MICHAEL M. KRAUSS, Assistant United States Attorney for the Southern District of New York (James B. Comey, United States Attorney, and Jeffrey S. Ostericher, Assistant United States Attorney, on the brief), for Defendant-Appellee United States of America.

PER CURIAM:

The sole issue on appeal is whether the district court had jurisdiction over Plaintiffs-Appellants' tax refund action. This Court holds that jurisdiction is not foreclosed by 26 U.S.C. §7422(h) (2000) and that the district court can properly exercise jurisdiction over this matter. Therefore, the district court's decision is reversed and the case is remanded for consideration of the merits of the action.

District courts generally have subject matter jurisdiction over tax refund claims pursuant to 28 U.S.C. §1346(a)(1). However, under 26 U.S.C. §7422(h), "[n]o action may be brought for a refund attributable to partnership items (as defined in section 6231(a)(3)) except as provided in section

6228(b) or section 6230(c)."[24] Based on a plain language reading of the statute, this provision does not bar jurisdiction. The statute indicates that for jurisdiction to be foreclosed, the refund (not the item which leads to that refund) must be attributable to partnership items. In other words, the refund must be based upon the assessment of a partnership item. This reading is further supported by the inclusion of the parenthetical reference to §6231(a)(3), which defines a "partnership item." Contrary to the United States' argument, the provision does not appear to bar jurisdiction in refund actions regarding a category of items that are termed "attributable to partnership items." Thus, it is only with respect to partnership items that a refund action is precluded. "If the refund is attributable to partnership items, section 7422(h) applies and deprives the court of jurisdiction. If, on the other hand, the refund is attributable to nonpartnership items, then section 7422(h) is irrelevant, and the general grant of jurisdiction [in 28 U.S.C. §1346(a)(1)] is effective." *Alexander v. United States*, 44 F.3d 328, 331 (5th Cir. 1995).

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[24] Neither exception to §7422(h) is applicable to this case. Plaintiffs-Appellants do not seek a refund based upon a computational error under §6230(c), nor do Plaintiffs-Appellants seek review of the Internal Revenue Service's ("IRS") denial of a request for an administrative adjustment under §6228(b).

There are three factors which lead this Court to find that the interest assessed against Plaintiffs-Appellants under former 26 U.S.C. §6621(c) is not a partnership item. First, the statutory definition of a "partnership item" is "any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level." 26 U.S.C. §6231(a)(3). The IRS's regulations list items considered to be partnership items. Thus 26 C.F.R. §301.6231(a)(3)-1 states that "the following items which are required to be taken into account for the taxable year of a partnership under subtitle A of the [Internal Revenue] Code are more appropriately determined at the partnership level than at the partner level and, therefore, are partnership items," and then lists various items, which do not include interest or §6621(c) interest. 26 C.F.R. §301.6231(a)(3)-1. Additionally, former 26 U.S.C. §6621(c) was a part of subtitle F and therefore was not an item "to be taken into account . . . under subtitle A." *Id.* Thus, the statutory definition of a "partnership item" and the IRS's regulations indicate that the §6621(c) interest is not a partnership item. The refund that Plaintiffs seek is therefore not attributable to a partnership item.

Second, the United States Tax Court has previously denied jurisdiction over claims

regarding §6621(c) interest on the ground that the §6621(c) interest is not a partnership item. For example, in *Affiliated Equipment Leasing II*, the Tax Court noted its prior holding that it "lack[s] jurisdiction in a partner level proceeding to determine whether a petitioner is liable for increased interest under section 6621(c) where the only matters in dispute were additions to tax" and concluded that "section 6621(c) interest is not a 'partnership item' and is not within the [Tax] Court's scope of review in a partnership level proceeding." *Affiliated Equip. Leasing II v. Commissioner*, 97 T.C. 575, 576-78 (1991) (citing *White v. Commissioner*, 95 T.C. 209, 212 (1991)). As recently as 2000, the Tax Court determined that §6621(c) interest is an "affected item"(as defined in the margin below)[25] rather than a "partnership item" and therefore could not be reviewed at a partnership level proceeding. *Barlow v. Commissioner*, Nos. 4651-95, 4652-95, 6393-95,

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[25] An "affected item" is defined as "any item to the extent such item is affected by a partnership item." 26 U.S.C. §6231(a)(5). As the Tax Court noted in *Barlow*, there are two types of affected items. The first type "is a computational adjustment made to record the change in a partner's tax liability resulting from the proper treatment of a partnership item." *Barlow*, 2000 Tax Ct. Memo LEXIS 402, at *49 (citation omitted). The second type is an item "that is dependent on factual determinations to be made at the individual partner level." *Id.* at *50. The Tax Court found that §6621(c) interest is the latter type of affected item. *Id.* at *50-*51.

6394-95, 2000 Tax Ct. Memo LEXIS 402, at *47-*51 (T.C. Nov. 3, 2000) ("Additional interest under section 6621 is an affected item because the determination of a taxpayer's liability for such interest may require findings of fact peculiar to the particular taxpayer, namely, the amount of the taxpayer's underpayment that is attributable to a tax-motivated transaction. Because the application of section 6621(c) turns on matters that are specific to individual partners, it follows that such interest constitutes an affected item that cannot be reviewed in a partnership level proceeding.") (citations omitted). These cases reinforce the view that the penalty interest at issue in this case is not attributable to a partnership item.

Third, the parties agree that the §6621(c) interest at issue is not a "partnership item." Counsel for the United States conceded at oral argument that the item at issue is not a partnership item but rather is properly considered an affected item. Plaintiffs have consistently argued that the penalty interest is not a partnership item. The United States argues that §7422(h) should be read to bar jurisdiction over claims for refunds where the item to be refunded is "attributable to a partnership item," meaning it directly flows from a partnership item. As discussed, a plain reading of §7422(h) defeats of this argument.

For the reasons set forth above, the judgment of the district court is hereby vacated and the matter remanded for consideration on the merits.

**Supreme Court of the United States**

FRANK LYON COMPANY, Petitioner,

v.

UNITED STATES.

**No. 76-624.**

Argued Nov. 2, 1977.

Decided April 18, 1978.

*CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT*

BLACKMUN, J., delivered the opinion of the Court, in which BURGER, C.J., and BRENNAN, STEWART, MARSHALL, POWELL, and REHNQUIST, JJ., joined. WHITE, J., filed a dissenting statement. STEVENS, J., filed a dissenting opinion.

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

This case concerns the federal income tax consequences of a sale-and-leaseback in which petitioner Frank Lyon Company (Lyon) took title to a building under construction by Worthen Bank & Trust Company (Worthen) of Little Rock, Ark., and simultaneously leased the building back to Worthen for long-term use as its headquarters and principal banking facility.

I

The underlying pertinent facts are undisputed. They are established by stipulations, App. 9, 14, the trial testimony, and the documentary evidence, and are reflected in the District Court's findings.

A

Lyon is a closely held Arkansas corporation engaged in the distribution of home furnishings, primarily Whirlpool and RCA electrical products. Worthen in 1965 was an Arkansas-chartered bank and a member of the Federal Reserve System. Frank Lyon was Lyon's majority shareholder and board chairman; he also served on Worthen's board. Worthen at that time began to plan the construction of a multistory bank and office building to replace its existing facility in Little Rock. About the same time Worthen's competitor, Union National Bank of Little Rock, also began to plan a new bank and office building. Adjacent sites on Capitol Avenue, separated only by Spring Street, were acquired by the two banks. It became a matter of competition, for both banking business and tenants, and prestige as to which bank would start and complete its building first.

Worthen initially hoped to finance, to build, and to own the proposed facility at a total cost of $9 million for the site, building, and adjoining parking deck. This was to be accomplished by selling $4 million in debentures and using the proceeds in the acquisition of the capital stock of a wholly owned real estate subsidiary. This subsidiary would have formal title and would raise the remaining $5

million by a conventional mortgage loan on the new premises. Worthen's plan, however, had to be abandoned for two significant reasons:

1. As a bank chartered under Arkansas law, Worthen legally could not pay more interest on any debentures it might issue than that then specified by Arkansas law. But the proposed obligations would not be marketable at that rate.

2. Applicable statutes or regulations of the Arkansas State Bank Department and the Federal Reserve System required Worthen, as a state bank subject to their supervision, to obtain prior permission for the investment in banking premises of any amount (including that placed in a real estate subsidiary) in excess of the bank's capital stock or of 40% of its capital stock and surplus.[1] See Ark.Stat.Ann. § 67-547.1 (Supp.1977); 12 U.S.C. § 371d (1976 ed.); 12 CFR § 265.2(f)(7) (1977). Worthen, accordingly, was advised by staff employees of the Federal Reserve System that they would not recommend approval of the plan by the System's Board of Governors.

Worthen therefore was forced to seek an alternative solution that would provide it with the use of the building, satisfy the state and federal

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[1] Worthen, as of June 30, 1967, had capital stock of $4 million and surplus of $5 million. During the period the building was under construction Worthen became a national bank subject to the supervision and control of the Comptroller of the Currency.

regulators, and attract the necessary capital. In September 1967 it proposed a sale-and-leaseback arrangement. The State Bank Department and the Federal Reserve System approved this approach, but the Department required that Worthen possess an option to purchase the leased property at the end of the 15th year of the lease at a set price, and the federal regulator required that the building be owned by an independent third party.

Detailed negotiations ensued with investors that had indicated interest, namely, Goldman, Sachs & Company; White, Weld & Co.; Eastman Dillon, Union Securities & Company; and Stephens, Inc. Certain of these firms made specific proposals.

Worthen then obtained a commitment from New York Life Insurance Company to provide $7,140,000 in permanent mortgage financing on the building, conditioned upon its approval of the titleholder. At this point Lyon entered the negotiations and it, too, made a proposal.

Worthen submitted a counterproposal that incorporated the best features, from its point of view, of the several offers. Lyon accepted the counterproposal, suggesting, by way of further inducement, a $21,000 reduction in the annual rent for the first five years of the building lease. Worthen selected Lyon as the investor. After further negotiations, resulting in the elimination of that rent reduction (offset, however, by higher interest Lyon was to pay Worthen on a subsequent

unrelated loan), Lyon in November 1967 was approved as an acceptable borrower by First National City Bank for the construction financing, and by New York Life, as the permanent lender. In April 1968 the approvals of the state and federal regulators were received.

In the meantime, on September 15, before Lyon was selected, Worthen itself began construction.

B

In May 1968 Worthen, Lyon, City Bank, and New York Life executed complementary and interlocking agreements under which the building was sold by Worthen to Lyon as it was constructed, and Worthen leased the completed building back from Lyon:

1. Agreements between Worthen and Lyon. Worthen and Lyon executed a ground lease, a sales agreement, and a building lease.

Under the ground lease dated May 1, 1968, App. 366, Worthen leased the site to Lyon for 76 years and 7 months through November 30, 2044. The first 19 months were the estimated construction period. The ground rents payable by Lyon to Worthen were $50 for the first 26 years and 7 months and thereafter in quarterly payments:

12/1/94 through 11/30/99 (5 years)-$100,000 annually

12/1/99 through 11/30/04 (5 years)-$150,000 annually

12/1/04 through 11/30/09 (5 years)-$200,000 annually

12/1/09 through 11/30/34 (25 years)-$250,000 annually

12/1/34 through 11/30/44 (10 years)-$10,000 annually.

Under the sales agreement dated May 19, 1968, *id.*, at 508, Worthen agreed to sell the building to Lyon, and Lyon agreed to buy it, piece by piece as it was constructed, for a total price not to exceed $7,640,000, in reimbursements to Worthen for its expenditures for the construction of the building.[2]

Under the building lease dated May 1, 1968, *id.*, at 376, Lyon leased the building back to Worthen for a primary term of 25 years from December 1, 1969, with options in Worthen to extend the lease for eight additional 5-year terms, a total of 65 years. During the period between the expiration of the building lease (at the latest, November 30, 2034, if fully extended) and the end of the ground lease on November 30, 2044, full ownership, use,

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[2] This arrangement appeared advisable and was made because purchases of materials by Worthen (which then had become a national bank) were not subject to Arkansas sales tax. See Ark.Stat.Ann. § 84-1904(*l* ) (1960); *First Agricultural Nat. Bank v. Tax Comm'n*, 392 U.S. 339, 88 S.Ct. 2173, 20 L.Ed.2d 1138 (1968). Sales of the building elements to Lyon also were not subject to state sales tax, since they were sales of real estate. See Ark.Stat.Ann. § 84-1902(c) (Supp.1977).

and control of the building were Lyon's, unless, of course, the building had been repurchased by Worthen. *Id.*, at 369. Worthen was not obligated to pay rent under the building lease until completion of the building. For the first 11 years of the lease, that is, until November 30, 1980, the stated quarterly rent was $145,581.03 ($582,324.12 for the year). For the next 14 years, the quarterly rent was $153,289.32 ($613,157.28 for the year), and for the option periods the rent was $300,000 a year, payable quarterly. *Id.*, at 378-379. The total rent for the building over the 25-year primary term of the lease thus was $14,989,767.24. That rent equaled the principal and interest payments that would amortize the $7,140,000 New York Life mortgage loan over the same period. When the mortgage was paid off at the end of the primary term, the annual building rent, if Worthen extended the lease, came down to the stated $300,000. Lyon's net rentals from the building would be further reduced by the increase in ground rent Worthen would receive from Lyon during the extension.[3]

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[3] This, of course, is on the assumption that Worthen exercises its option to extend the building lease. If it does not, Lyon remains liable for the substantial rents prescribed by the ground lease. This possibility brings into sharp focus the fact that Lyon, in a very practical sense, is at least the ultimate owner of the building. If Worthen does not extend, the building lease expires and Lyon may do with the building as it chooses.

The Government would point out, however, that the net amounts payable by Worthen to Lyon during the building lease's extended terms, if all are claimed, would approximate the amount required to repay Lyon's $500,000 investment at 6% compound interest. Brief for United States 14.

The building lease was a "net lease," under which Worthen was responsible for all expenses usually associated with the maintenance of an office building, including repairs, taxes, utility charges, and insurance, and was to keep the premises in good condition, excluding, however, reasonable wear and tear.

Finally, under the lease, Worthen had the option to repurchase the building at the following times and prices:

11/30/80 (after 11 years)-$6,325,169.85

11/30/84 (after 15 years)-$5,432,607.32

11/30/89 (after 20 years)-$4,187,328.04

11/30/94 (after 25 years)-$2,145,935.00

These repurchase option prices were the sum of the unpaid balance of the New York Life mortgage, Lyon's $500,000 investment, and 6% interest compounded on that investment.

2. Construction financing agreement. By agreement dated May 14, 1968, *id.*, at 462, City Bank agreed to lend Lyon $7,000,000 for the construction of the building. This loan was secured

by a mortgage on the building and the parking deck, executed by Worthen as well as by Lyon, and an assignment by Lyon of its interests in the building lease and in the ground lease.

3. Permanent financing agreement. By Note Purchase Agreement dated May 1, 1968, *id.*, at 443, New York Life agreed to purchase Lyon's $7,140,000 6 3/4 % 25-year secured note to be issued upon completion of the building. Under this agreement Lyon warranted that it would lease the building to Worthen for a noncancelable term of at least 25 years under a net lease at a rent at least equal to the mortgage payments on the note. Lyon agreed to make quarterly payments of principal and interest equal to the rentals payable by Worthen during the corresponding primary term of the lease. *Id.*, at 523. The security for the note was a first deed of trust and Lyon's assignment of its interests in the building lease and in the ground lease. *Id.*, at 527, 571. Worthen joined in the deed of trust as the owner of the fee and the parking deck.

In December 1969 the building was completed and Worthen took possession. At that time Lyon received the permanent loan from New York Life, and it discharged the interim loan from City Bank. The actual cost of constructing the office building and parking complex (excluding the cost of the land) exceeded $10,000,000.

C

Lyon filed its federal income tax returns on the accrual and calendar year basis. On its 1969 return, Lyon accrued rent from Worthen for December. It asserted as deductions one month's interest to New York Life; one month's depreciation on the building; interest on the construction loan from City Bank; and sums for legal and other expenses incurred in connection with the transaction.

On audit of Lyon's 1969 return, the Commissioner of Internal Revenue determined that Lyon was "not the owner for tax purposes of any portion of the Worthen Building," and ruled that "the income and expenses related to this building are not allowable . . . for Federal income tax purposes." App. 304-305, 299. He also added $2,298.15 to Lyon's 1969 income as "accrued interest income." This was the computed 1969 portion of a gain, considered the equivalent of interest income, the realization of which was based on the assumption that Worthen would exercise its option to buy the building after 11 years, on November 30, 1980, at the price stated in the lease, and on the additional determination that Lyon had "loaned" $500,000 to Worthen. In other words, the Commissioner determined that the sale-and-leaseback arrangement was a financing transaction in which Lyon loaned Worthen $500,000 and acted as a conduit for the transmission of principal and interest from Worthen to New York Life.

All this resulted in a total increase of $497,219.18 over Lyon's reported income for 1969, and a deficiency in Lyon's federal income tax for that year in the amount of $236,596.36. The Commissioner assessed that amount, together with interest of $43,790.84, for a total of $280,387.20.[4]

Lyon paid the assessment and filed a timely claim for its refund. The claim was denied, and this suit, to recover the amount so paid, was instituted in the United States District Court for the Eastern District of Arkansas within the time allowed by 26 U.S.C. § 6532(a)(1).

After trial without a jury, the District Court, in a memorandum letter-opinion setting forth findings and conclusions, ruled in Lyon's favor and held that its claimed deductions were allowable. 75-2 USTC ¶ 9545 (1975); 36 AFTR 2d ¶ 75-5059 (1975); App. 296-311. It concluded that the legal intent of the parties had been to create a bona fide sale-and-leaseback in accordance with the form and language of the documents evidencing the transactions. It rejected the argument that Worthen was acquiring an equity in the building through its rental payments. It found that the rents were unchallenged and were reasonable throughout the period of the lease, and that the option prices, negotiated at arm's length between the parties, represented fair estimates of market

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[4] These figures do not include uncontested adjustments not involved in this litigation.

value on the applicable dates. It rejected any negative inference from the fact that the rentals, combined with the options, were sufficient to amortize the New York Life loan and to pay Lyon a 6% return on its equity investment. It found that Worthen would acquire an equity in the building only if it exercised one of its options to purchase, and that it was highly unlikely, as a practical matter, that any purchase option would ever be exercised. It rejected any inference to be drawn from the fact that the lease was a "net lease." It found that Lyon had mixed motivations for entering into the transaction, including the need to diversify as well as the desire to have the benefits of a "tax shelter." App. 296, 299.

The United States Court of Appeals for the Eighth Circuit reversed. 536 F.2d 746 (1976). It held that the Commissioner correctly determined that Lyon was not the true owner of the building and therefore was not entitled to the claimed deductions. It likened ownership for tax purposes to a "bundle of sticks" and undertook its own evaluation of the facts. It concluded, in agreement with the Government's contention, that Lyon "totes an empty bundle" of ownership sticks. *Id.*, at 751. It stressed the following: (a) The lease agreements circumscribed Lyon's right to profit from its investment in the building by giving Worthen the option to purchase for an amount equal to Lyon's $500,000 equity plus 6% compound interest and the assumption of the unpaid balance of the New

York Life mortgage.[5] (b) The option prices did not take into account possible appreciation of the value of the building or inflation.[6] (c) Any award realized as a result of destruction or condemnation of the building in excess of the mortgage balance and the $500,000 would be paid to Worthen and not Lyon.[7] (d) The building rental payments during the primary term were exactly equal to the mortgage

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[5] Lyon here challenges this assertion on the grounds that it had the right and opportunities to sell the building at a greater profit at any time; the return to Lyon was not insubstantial and was attractive to a true investor in real estate; the 6% return was the minimum Lyon would realize if Worthen exercised one of its options, an event the District Court found highly unlikely; and Lyon would own the building and realize a greater return than 6% if Worthen did not exercise an option to purchase.

[6] Lyon challenges this observation by pointing out that the District Court found the option prices to be the negotiated estimate of the parties of the fair market value of the building on the option dates and to be reasonable. App. 303, 299.

[7] Lyon asserts that this statement is true only with respect to the total destruction or taking of the building on or after December 1, 1980. Lyon asserts that it, not Worthen, would receive the excess above the mortgage balance in the event of total destruction or taking before December 1, 1980, or in the event of partial damage or taking at any time. *Id.*, at 408-410, 411.

payments.[8] (e) Worthen retained control over the ultimate disposition of the building through its various options to repurchase and to renew the lease plus its ownership of the site.[9] (f) Worthen enjoyed all benefits and bore all burdens incident to the operation and ownership of the building so that, in the Court of Appeals' view, the only economic advantages accruing to Lyon, in the event it were considered to be the true owner of the property, were income tax savings of approximately $1.5 million during the first 11

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[8] Lyon concedes the accuracy of this statement, but asserts that it does not justify the conclusion that Lyon served merely as a conduit by which mortgage payments would be transmitted to New York Life. It asserts that Lyon was the sole obligor on the New York Life note and would remain liable in the event of default by Worthen. It also asserts that the fact the rent was sufficient to amortize the loan during the primary term of the lease was a requirement imposed by New York Life, and is a usual requirement in most long-term loans secured by a long-term lease.

[9] As to this statement, Lyon asserts that the Court of Appeals ignored Lyon's right to sell the building to another at any time; the District Court's finding that the options to purchase were not likely to be exercised; the uncertainty that Worthen would renew the lease for 40 years; Lyon's right to lease to anyone at any price during the last 10 years of the ground lease; and Lyon's continuing ownership of the building after the expiration of the ground lease.

years of the arrangement.[10] *Id.*, at 752-753.[11] The court concluded, *id.*, at 753, that the transaction was "closely akin" to that in *Helvering v. Lazarus & Co.*, 308 U.S. 252, 60 S.Ct. 209, 84 L.Ed. 226 (1939). "In sum, the benefits, risks, and burdens which [Lyon] has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes. . . . The vice of the present lease is that all of [its] features have been employed in the same transaction with the cumulative effect of depriving [Lyon] of any significant ownership interest." 536 F.2d, at 754.

We granted certiorari, 429 U.S. 1089, 97 S.Ct. 1097, 51 L.Ed.2d 534 (1977), because of an

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[10] In response to this, Lyon asserts that the District Court found that the benefits of occupancy Worthen will enjoy are common in most long-term real estate leases, and that the District Court found that Lyon had motives other than tax savings in entering into the transaction. It also asserts that the net cash after-tax benefit would be $312,220, not $1.5 million.

[11] Other factors relied on by the Court of Appeals, 536 F.2d, at 752, were the allocation of the investment credit to Worthen, and a claim that Lyon's ability to sell the building to a third party was "carefully circumscribed" by the lease agreements. The investment credit by statute is freely allocable between the parties, § 48(d) of the 1954 Code, 26 U.S.C. § 48(d), and the Government has not pressed either of these factors before this Court.

indicated conflict with *American Realty Trust v. United States*, 498 F.2d 1194 (CA 4 1974).

II

This Court, almost 50 years ago, observed that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed-the actual benefit for which the tax is paid." *Corliss v. Bowers*, 281 U.S. 376, 378, 50 S.Ct. 336, 74 L.Ed. 916 (1930). In a number of cases, the Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred. *E. g., Commissioner of Internal Revenue v. Sunnen*, 333 U.S. 591, 68 S.Ct. 715, 92 L.Ed. 898 (1948); *Helvering v. Clifford*, 309 U.S. 331, 60 S.Ct. 554, 84 L.Ed. 788 (1940). In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," *Commissioner of Internal Revenue v. Tower*, 327 U.S. 280, 291, 66 S.Ct. 532, 538, 90 L.Ed. 670 (1946), as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering v. Lazarus & Co.*, 308 U.S., at 255, 60

S.Ct., at 210. See also *Commissioner of Internal Revenue v. P. G. Lake, Inc.*, 356 U.S. 260, 266-267, 78 S.Ct. 691, 2 L.Ed.2d 743 (1958); *Commissioner of Internal Revenue v. Court Holding Co.*, 324 U.S. 331, 334, 65 S.Ct. 707, 89 L.Ed. 981 (1945). Nor is the parties' desire to achieve a particular tax result necessarily relevant. *Commissioner of Internal Revenue v. Duberstein*, 363 U.S. 278, 286, 80 S.Ct. 1190, 4 L.Ed.2d 1218 (1960).

In the light of these general and established principles, the Government takes the position that the Worthen-Lyon transaction in its entirety should be regarded as a sham. The agreement as a whole, it is said, was only an elaborate financing scheme designed to provide economic benefits to Worthen and a guaranteed return to Lyon. The latter was but a conduit used to forward the mortgage payments, made under the guise of rent paid by Worthen to Lyon, on to New York Life as mortgagee. This, the Government claims, is the true substance of the transaction as viewed under the microscope of the tax laws. Although the arrangement was cast in sale-and-leaseback form, in substance it was only a financing transaction, and the terms of the repurchase options and lease renewals so indicate. It is said that Worthen could reacquire the building simply by satisfying the mortgage debt and paying Lyon its $500,000 advance plus interest, regardless of the fair market value of the building at the time; similarly, when the mortgage was paid off, Worthen could extend the lease at drastically reduced bargain rentals

that likewise bore no relation to fair rental value but were simply calculated to pay Lyon its $500,000 plus interest over the extended term. Lyon's return on the arrangement in no event could exceed 6% compound interest (although the Government conceded it might well be less, Tr. of Oral Arg. 32). Furthermore, the favorable option and lease renewal terms made it highly unlikely that Worthen would abandon the building after it in effect had "paid off" the mortgage. The Government implies that the arrangement was one of convenience which, if accepted on its face, would enable Worthen to deduct its payments to Lyon as rent and would allow Lyon to claim a deduction for depreciation, based on the cost of construction ultimately borne by Worthen, which Lyon could offset against other income, and to deduct mortgage interest that roughly would offset the inclusion of Worthen's rental payments in Lyon's income. If, however, the Government argues, the arrangement was only a financing transaction under which Worthen was the owner of the building, Worthen's payments would be deductible only to the extent that they represented mortgage interest, and Worthen would be entitled to claim depreciation; Lyon would not be entitled to deductions for either mortgage interest or depreciation and it would not have to include Worthen's "rent" payments in its income because its function with respect to those payments was that of a conduit between Worthen and New York Life.

The Government places great reliance on *Helvering v. Lazarus & Co., supra*, and claims it to be precedent that controls this case. The taxpayer there was a department store. The legal title of its three buildings was in a bank as trustee for land-trust certificate holders. When the transfer to the trustee was made, the trustee at the same time leased the buildings back to the taxpayer for 99 years, with option to renew and purchase. The Commissioner, in stark contrast to his posture in the present case, took the position that the statutory right to depreciation followed legal title. The Board of Tax Appeals, however, concluded that the transaction between the taxpayer and the bank in reality was a mortgage loan and allowed the taxpayer depreciation on the buildings. This Court, as had the Court of Appeals, agreed with that conclusion and affirmed. It regarded the "rent" stipulated in the leaseback as a promise to pay interest on the loan, and a "depreciation fund" required by the lease as an amortization fund designed to pay off the loan in the stated period. Thus, said the Court, the Board justifiably concluded that the transaction, although in written form a transfer of ownership with a leaseback, was actually a loan secured by the property involved.

The *Lazarus* case, we feel, is to be distinguished from the present one and is not controlling here. Its transaction was one involving only two (and not multiple) parties, the taxpayer-department store and the trustee-bank. The Court looked closely at the substance of the agreement between those two

parties and rightly concluded that depreciation was deductible by the taxpayer despite the nomenclature of the instrument of conveyance and the leaseback. See also *Sun Oil Co. v. Commissioner of Internal Revenue*, 562 F.2d 258 (CA 3 1977) (a two-party case with the added feature that the second party was a tax-exempt pension trust).

The present case, in contrast, involves three parties, Worthen, Lyon, and the finance agency. The usual simple two-party arrangement was legally unavailable to Worthen. Independent investors were interested in participating in the alternative available to Worthen, and Lyon itself (also independent from Worthen) won the privilege. Despite Frank Lyon's presence on Worthen's board of directors, the transaction, as it ultimately developed, was not a familial one arranged by Worthen, but one compelled by the realities of the restrictions imposed upon the bank. Had Lyon not appeared, another interested investor would have been selected. The ultimate solution would have been essentially the same. Thus, the presence of the third party, in our view, significantly distinguishes this case from *Lazarus* and removes the latter as controlling authority.

III

It is true, of course, that the transaction took shape according to Worthen's needs. As the Government points out, Worthen throughout the negotiations regarded the respective proposals of

the independent investors in terms of its own cost of funds. *E. g.*, App. 355. It is also true that both Worthen and the prospective investors compared the various proposals in terms of the return anticipated on the investor's equity. But all this is natural for parties contemplating entering into a transaction of this kind. Worthen needed a building for its banking operations and other purposes and necessarily had to know what its cost would be. The investors were in business to employ their funds in the most remunerative way possible. And, as the Court has said in the past, a transaction must be given its effect in accord with what actually occurred and not in accord with what might have occurred. *Commissioner of Internal Revenue v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148-149, 94 S.Ct. 2129, 40 L.Ed.2d 717 (1974); *Central Tablet Mfg. Co. v. United States*, 417 U.S. 673, 690, 94 S.Ct. 2516, 41 L.Ed.2d 398 (1974).

There is no simple device available to peel away the form of this transaction and to reveal its substance. The effects of the transaction on all the parties were obviously different from those that would have resulted had Worthen been able simply to make a mortgage agreement with New York Life and to receive a $500,000 loan from Lyon. Then *Lazarus* would apply. Here, however, and most significantly, it was Lyon alone, and not Worthen, who was liable on the notes, first to City Bank, and then to New York Life. Despite the facts that Worthen had agreed to pay rent and that this rent

equaled the amounts due from Lyon to New York Life, should anything go awry in the later years of the lease, Lyon was primarily liable.[12] No matter how the transaction could have been devised otherwise, it remains a fact that as the agreements were placed in final form, the obligation on the notes fell squarely on Lyon.[13] Lyon, an ongoing enterprise, exposed its very business well-being to this real and substantial risk.

The effect of this liability on Lyon is not just the abstract possibility that something will go wrong and that Worthen will not be able to make its payments. Lyon has disclosed this liability on its balance sheet for all the world to see. Its financial position was affected substantially by the presence of this long-term debt, despite the offsetting presence of the building as an asset. To the extent that Lyon has used its capital in this transaction, it is less able to obtain financing for other business needs.

In concluding that there is this distinct element of economic reality in Lyon's assumption of

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[12] New York Life required Lyon, not Worthen, to submit financial statements periodically. See Note Purchase Agreement, App. 453-454, 458-459.

[13] It may well be that the remedies available to New York Life against Lyon would be far greater than any remedy available to it against Worthen, which, as lessee, is liable to New York Life only through Lyon's assignment of its interest as lessor.

liability, we are mindful that the characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same. *Commissioner of Internal Revenue v. Lincoln Savings & Loan Assn.*, 403 U.S. 345, 355, 91 S.Ct. 1893, 29 L.Ed.2d 519 (1971); *Old Colony R. Co. v. Commissioner of Internal Revenue*, 284 U.S. 552, 562, 52 S.Ct. 211, 76 L.Ed. 484 (1932). Accounting methods or descriptions, without more, do not lend substance to that which has no substance. But in this case accepted accounting methods, as understood by the several parties to the respective agreements and as applied to the transaction by others, gave the transaction a meaningful character consonant with the form it was given.[14]

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[14] We are aware that accounting standards have changed significantly since 1968 and that the propriety of Worthen's and Lyon's methods of disclosing the transaction in question may be a matter for debate under these new standards. Compare Accounting Principles Bd. Opinion No. 5, Reporting of Leases in Financial Statements of Lessee (1964), and Accounting Principles Bd. Opinion No. 7, Accounting for Leases in Financial Statements of Lessors (1966), with Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 13, Accounting for Leases (1976). See also Comptroller of the Currency, Banking Circular No. 95 (Nov. 11, 1977), instructing that national banks revise their financial statements in accord with FASB Standard No. 13. Standard No. 13, however, by its terms, states, ¶ 78, that there are many instances where tax and financial accounting treatments diverge. Further, Standard No. 13 is

Worthen was not allowed to enter into the type of transaction which the Government now urges to be the true substance of the arrangement. Lyon and Worthen cannot be said to have entered into the transaction intending that the interests involved were allocated in a way other than that associated with a sale-and-leaseback.

Then-existing pronouncements of the Internal Revenue Service gave Lyon very little against which to measure the transaction. The most complete statement on the general question of characterization of leases as sales, Rev.Rul: 55-540, 1955-2 Cum.Bull. 39, by its terms dealt only with equipment leases. In that ruling it was stated that the Service will look at the intent of the parties at the time the agreement was executed to determine the proper characterization of the transaction. Generally, an intent to enter into a conditional sales agreement will be found to be present if (a) portions of the rental payments are made specifically applicable to an equity acquired by the lessee, (b) the lessee will acquire a title automatically after certain payments have been made, (c) the rental payments are a disproportionately large amount in relation to the sum necessary to complete the sale, (d) the rental

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nonapplicable with respect to a lease executed prior to January 1, 1977 (as was the Lyon-Worthen lease), until January 1, 1981. Obviously, Banking Circular No. 95 was not in effect in 1968 when the Lyon-Worthen lease was executed.

payments are above fair rental value, (e) title can be acquired at a nominal option price, or (f) some portion of the rental payments are identifiable as interest. See also Rev.Rul. 60-122, 1960-1 Cum.Bull. 56; Rev.Rul. 72-543, 1972-2 Cum.Bull. 87.

The Service announced more specific guidelines, indicating under what circumstances it would answer requests for rulings on leverage leasing transactions, in Rev.Proc. 75-21, 1975-1 Cum.Bull. 715. In general "[u]nless other facts and circumstances indicate a contrary intent," the Service will not rule that a lessor in a leveraged lease transaction is to be treated as the owner of the property in question unless (a) the lessor has incurred and maintains a minimal investment equal to 20% of the cost of the property, (b) the lessee has no right to purchase except at fair market value, (c) no part of the cost of the property is furnished by the lessee, (d) the lessee has not lent to the lessor or guaranteed any indebtedness of the lessor, and (e) the lessor must demonstrate that it expects to receive a profit on the transaction other than the benefits received solely from the tax treatment. These guidelines are not intended to be definitive, and it is not clear that they provide much guidance in assessing real estate transactions. See Rosenberg & Weinstein, Sale-leasebacks: An analysis of these transactions after the Lyon decision, 45 J.Tax. 146, 147 n. 1 (1976).

Other factors also reveal that the transaction cannot be viewed as anything more than a mortgage agreement between Worthen and New York Life and a loan from Lyon to Worthen. There is no legal obligation between Lyon and Worthen representing the $500,000 "loan" extended under the Government's theory. And the assumed 6% return on this putative loan-required by the audit to be recognized in the taxable year in question-will be realized only when and if Worthen exercises its options.

The Court of Appeals acknowledged that the rents alone, due after the primary term of the lease and after the mortgage has been paid, do not provide the simple 6% return which, the Government urges, Lyon is guaranteed, 536 F.2d, at 752. Thus, if Worthen chooses not to exercise its options, Lyon is gambling that the rental value of the building during the last 10 years of the ground lease, during which the ground rent is minimal, will be sufficient to recoup its investment before it must negotiate again with Worthen regarding the ground lease. There are simply too many contingencies, including variations in the value of real estate, in the cost of money, and in the capital structure of Worthen, to permit the conclusion that the parties intended to enter into the transaction as structured in the audit and according to which the Government now urges they be taxed.

It is not inappropriate to note that the Government is likely to lose little revenue, if any,

as a result of the shape given the transaction by the parties. No deduction was created that is not either matched by an item of income or that would not have been available to one of the parties if the transaction had been arranged differently. While it is true that Worthen paid Lyon less to induce it to enter into the transaction because Lyon anticipated the benefit of the depreciation deductions it would have as the owner of the building, those deductions would have been equally available to Worthen had it retained title to the building. The Government so concedes. Tr. of Oral Arg. 22-23. The fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences.[15] We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction. See *Commissioner of Internal Revenue v. Brown*, 380 U.S. 563, 579-580, 85 S.Ct. 1162, 14 L.Ed.2d 75 (1965) (Harlan, J., concurring). Lyon is not a corporation with no purpose other than to hold title

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[15] Indeed, it is not inevitable that the transaction, as treated by Lyon and Worthen, will not result in more revenues to the Government rather than less. Lyon is gambling that in the first 11 years of the lease it will have income that will be sheltered by the depreciation deductions, and that it will be able to make sufficiently good use of the tax dollars preserved thereby to make up for the income it will recognize and pay taxes on during the last 14 years of the initial term of the lease and against which it will enjoy no sheltering deduction.

to the bank building. It was not created by Worthen or even financed to any degree by Worthen.

The conclusion that the transaction is not a simple sham to be ignored does not, of course, automatically compel the further conclusion that Lyon is entitled to the items claimed as deductions. Nevertheless, on the facts, this readily follows. As has been noted, the obligations on which Lyon paid interest were its obligations alone, and it is entitled to claim deductions therefor under § 163(a) of the 1954 Code, 26 U.S.C. § 163(a).

As is clear from the facts, none of the parties to this sale-and-leaseback was the owner of the building in any simple sense. But it is equally clear that the facts focus upon Lyon as the one whose capital was committed to the building and as the party, therefore, that was entitled to claim depreciation for the consumption of that capital. The Government has based its contention that Worthen should be treated as the owner on the assumption that throughout the term of the lease Worthen was acquiring an equity in the property. In order to establish the presence of that growing equity, however, the Government is forced to speculate that one of the options will be exercised and that, if it is not, this is only because the rentals for the extended term are a bargain. We cannot indulge in such speculation in view of the

District Court's clear finding to the contrary.[16] We therefore conclude that it is Lyon's capital that is invested in the building according to the agreement of the parties, and it is Lyon that is entitled to depreciation deductions, under § 167 of the 1954 Code, 26 U.S.C. § 167. Cf. *United States v. Chicago B. & Q. R. Co.*, 412 U.S. 401, 93 S.Ct. 2169, 37 L.Ed.2d 30 (1973).

## IV

We recognize that the Government's position, and that taken by the Court of Appeals, is not without superficial appeal. One, indeed, may theorize that Frank Lyon's presence on the Worthen board of directors; Lyon's departure from its principal corporate activity into this unusual venture; the parallel between the payments under the building lease and the amounts due from Lyon on the New York Life mortgage; the provisions relating to condemnation or destruction of the property; the nature and presence of the several options available to Worthen; and the tax benefits, such as the use of double declining balance depreciation, that accrue to Lyon during the initial years of the arrangement, form the basis of an argument that Worthen should be regarded as the

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[16] The general characterization of a transaction for tax purposes is a question of law subject to review. The particular facts from which the characterization is to be made are not so subject. See *American Realty Trust v. United States*, 498 F.2d 1194, 1198 (CA 4 1974).

owner of the building and as the recipient of nothing more from Lyon than a $500,000 loan.

We however, as did the District Court, find this theorizing incompatible with the substance and economic realities of the transaction: the competitive situation as it existed between Worthen and Union National Bank in 1965 and the years immediately following; Worthen's undercapitalization; Worthen's consequent inability, as a matter of legal restraint, to carry its building plans into effect by a conventional mortgage and other borrowing; the additional barriers imposed by the state and federal regulators; the suggestion, forthcoming from the state regulator, that Worthen possess an option to purchase; the requirement, from the federal regulator, that the building be owned by an independent third party; the presence of several finance organizations seriously interested in participating in the transaction and in the resolution of Worthen's problem; the submission of formal proposals by several of those organizations; the bargaining process and period that ensued; the competitiveness of the bidding; the bona fide character of the negotiations; the three-party aspect of the transaction; Lyon's substantiality[17]

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[17] Lyon's consolidated balance sheet on December 31, 1968, showed assets of $12,225,612, and total stockholders' equity of $3,818,671. Of the assets, the sum of $2,674,290 represented its then investment in the Worthen building. App. 587-588.

and its independence from Worthen; the fact that diversification was Lyon's principal motivation; Lyon's being liable alone on the successive notes to City Bank and New York Life; the reasonableness, as the District Court found, of the rentals and of the option prices; the substantiality of the purchase prices; Lyon's not being engaged generally in the business of financing; the presence of all building depreciation risks on Lyon; the risk borne by Lyon, that Worthen might default or fail, as other banks have failed; the facts that Worthen could "walk away" from the relationship at the end of the 25-year primary term, and probably would do so if the option price were more than the then-current worth of the building to Worthen; the inescapable fact that if the building lease were not extended, Lyon would be the full owner of the building, free to do with it as it chose; Lyon's liability for the substantial ground rent if Worthen decides not to exercise any of its options to extend; the absence of any understanding between Lyon and Worthen that Worthen would exercise any of the purchase options; the nonfamily and nonprivate nature of the entire transaction; and the absence of any differential in tax rates and of special tax circumstances for one of the parties-all convince us that Lyon has far the better of the case.[18]

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[18] Thus, the facts of this case stand in contrast to many others in which the form of the transaction actually created tax advantages that, for one reason or another, could not

In so concluding, we emphasize that we are not condoning manipulation by a taxpayer through arbitrary labels and dealings that have no economic significance. Such, however, has not happened in this case.

In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts. It suffices to say that, as here, a

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have been enjoyed had the transaction taken another form. See, *e. g., Sun Oil Co. v. Commissioner of Internal Revenue*, 562 F.2d 258 (CA 3 1977) (sale-and-leaseback of land between taxpayer and tax-exempt trust enabled the taxpayer to amortize, through its rental deductions, the cost of acquiring land not otherwise depreciable). Indeed, the arrangements in this case can hardly be labeled as tax-avoidance techniques in light of the other arrangements being promoted at the time. See, *e. g.*, Zeitlin, Tax Planning in Equipment-Leasing Shelters, 1969 So.Cal. Tax Inst. 621; Marcus, Real Estate Purchase-Leasebacks as Secured Loans, 2 Real Estate L.J. 664 (1974).

sale-and-leaseback, in and of itself, does not necessarily operate to deny a taxpayer's claim for deductions.[19]

The judgment of the Court of Appeals, accordingly, is reversed.

*It is so ordered.*

Mr. Justice WHITE dissents and would affirm the judgment substantially for the reasons stated in the opinion in the Court of Appeals for the Eighth Circuit. 536 F.2d 746 (1976).

Mr. Justice STEVENS, dissenting.

In my judgment the controlling issue in this case is the economic relationship between Worthen and petitioner, and matters such as the number of parties, their reasons for structuring the transaction in a particular way, and the tax benefits which may result, are largely irrelevant. The question whether a leasehold has been created should be answered by examining the character

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[19] See generally *Commissioner of Internal Revenue v. Danielson*, 378 F.2d 771 (CA 3), cert. denied, 389 U.S. 858, 88 S.Ct. 94, 19 L.Ed.2d 123 (1967), on remand, 50 T.C. 782 (1968); *Levinson v. Commissioner of Internal Revenue*, 45 T.C. 380 (1966); *World Publishing Co. v. Commissioner of Internal Revenue*, 299 F.2d 614 (CA 8 1962); *Northwest Acceptance Corp. v. Commissioner of Internal Revenue*, 58 T.C. 836 (1972), aff'd, 500 F.2d 1222 (CA 9 1974); *Cubic Corp. v. United States*, 541 F.2d 829 (CA 9 1976).

and value of the purported lessor's reversionary estate.

For a 25-year period Worthen has the power to acquire full ownership of the bank building by simply repaying the amounts, plus interest, advanced by the New York Life Insurance Company and petitioner. During that period, the economic relationship among the parties parallels exactly the normal relationship between an owner and two lenders, one secured by a first mortgage and the other by a second mortgage.[1] If Worthen repays both loans, it will have unencumbered ownership of the property. What the character of this relationship suggests is confirmed by the economic value that the parties themselves have placed on the reversionary interest.

All rental payments made during the original 25-year term are credited against the option repurchase price, which is exactly equal to the unamortized cost of the financing. The value of the repurchase option is thus limited to the cost of the financing, and Worthen's power to exercise the option is cost free. Conversely, petitioner, the nominal owner of the reversionary estate, is not

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[1] "[W]here a fixed price, as in *Frank Lyon Company*, is designed merely to provide the lessor with a predetermined fixed return, the substantive bargain is more akin to the relationship between a debtor and creditor than between a lessor and lessee." Rosenberg & Weinstein, Sale-leasebacks: An analysis of these transactions after the Lyon decision, 45 J.Tax. 146, 149 (1976).

entitled to receive *any* value for the surrender of its supposed rights of ownership.[2] Nor does it have any power to control Worthen's exercise of the option.[3]

"It is fundamental that 'depreciation is not predicated upon ownership of property *but rather upon an investment in property*.' No such investment exists when payments of the purchase

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[2] It is worth noting that the proposals submitted by two other potential investors in the building, see *ante*, at 1294, did contemplate that Worthen would pay a price above the financing costs for acquisition of the leasehold interest. For instance, Goldman, Sachs & Company proposed that, at the end of the lease's primary term, Worthen would have the option to repurchase the property for either its fair market value or 20% of its original cost, whichever was the greater. See Brief for United States 8 n. 7. A repurchase option based on fair market value, since it acknowledges the lessor's equity interest in the property, is consistent with a lessor-lessee relationship. See *Breece Veneer & Panel Co. v. Commissioner of Internal Revenue*, 232 F.2d 319 (CA 7 1956); *LTV Corp. v. Commissioner*, 63 T.C. 39, 50 (1974); see generally Comment, Sale and Leaseback Transactions, 52 N.Y.U.L.Rev. 672, 688-689, n. 117 (1977).

[3] The situation in this case is thus analogous to that in *Corliss v. Bowers*, 281 U.S. 376, 50 S.Ct. 336, 74 L.Ed. 916, where the Court held that the grantor of a trust who retains an unrestricted cost-free power of revocation remains the owner of the trust assets for tax purposes. Worthen's power to exercise its repurchase option is similar; the only restraints upon it are those normally associated with the repayment of a loan, such as limitations on the timing of repayment and the amount due at the stated intervals.

price in accordance with the design of the parties yield no equity to the purchaser." *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1049 (CA 9 1976) (citations omitted; emphasis in original). Here, the petitioner has, in effect, been guaranteed that it will receive its original $500,000 plus accrued interest. But that is all. It incurs neither the risk of depreciation,[4] nor the benefit of possible appreciation. Under the terms of the sale-leaseback, it will stand in no better or worse position after the 11th year of the lease-when Worthen can first exercise its option to repurchase-whether the property has appreciated

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[4] Petitioner argues that it bears the risk of depreciation during the primary term of the lease, because the option price decreases over time. Brief for Petitioner 29-30. This is clearly incorrect. Petitioner will receive $500,000 plus interest, and no more or less, whether the option is exercised as soon as possible or only at the end of 25 years. Worthen, on the other hand, does bear the risk of depreciation, since its opportunity to make a profit from the exercise of its repurchase option hinges on the value of the building at the time.

or depreciated.[5] And this remains true throughout the rest of the 25-year period.

Petitioner has assumed only two significant risks. First, like any other lender, it assumed the risk of Worthen's insolvency. Second, it assumed the risk that Worthen might *not* exercise its option to purchase at or before the end of the original 25-year term.[6] If Worthen should exercise that right *not* to repay, perhaps it would *then* be appropriate to characterize petitioner as the owner and Worthen as the lessee. But speculation as to what might happen in 25 years cannot justify the *present* characterization of petitioner as the owner of the building. Until Worthen has made a commitment either to exercise or not to exercise its

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[5] After the 11th year of the lease, there are three ways that the lease might be terminated. The property might be condemned, the building might be destroyed by act of God, or Worthen might exercise its option to purchase. In any such event, if the property had increased in value, the entire benefit would be received by Worthen and petitioner would receive only its $500,000 plus interest. See Reply Brief for Petitioner 8-9, n. 2.

[6] The possibility that Worthen might not exercise its option is a risk for petitioner because in that event petitioner's advance would be amortized during the ensuing renewal lease terms, totaling 40 years. Yet there is a possibility that Worthen would choose not to renew for the full 40 years or that the burdens of owning a building and paying a ground rental of $10,000 during the years 2034 through 2044 would exceed the benefits of ownership. *Ante*, at 1301.

option,[7] I think the Government is correct in its view that petitioner is not the owner of the building for tax purposes. At present, since Worthen has the unrestricted right to control the residual value of the property for a price which does not exceed the cost of its unamortized financing, I would hold, as a matter of law, that it is the owner.

In effect, Worthen has an option to "put" the building to petitioner if it drops in value below $500,000 plus interest. Even if the "put" appears likely because of bargain lease rates after the primary terms, that would not justify the present characterization of petitioner as the owner of the building.

I therefore respectfully dissent.

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[7] In this case, the lessee is not "economically compelled" to exercise its option. See *American Realty Trust v. United States*, 498 F.2d 1194 (CA 4 1974). Indeed, it may be more advantageous for Worthen to let its option lapse since the present value of the renewal leases is somewhat less than the price of the option to repurchase. See Brief for United States 40 n. 26. But whether or not Worthen is likely to exercise the option, as long as it retains its unrestricted cost-free power to do so, it must be considered the owner of the building. See *Sun Oil Co. v. Commissioner of Internal Revenue*, 562 F.2d 258, 267 (CA 3 1977) (repurchase option enabling lessee to acquire leased premises by repaying financing costs indicative of lessee's equity interest in those premises).

**Supreme Court of the United States**

GREGORY

v.

HELVERING,

Commissioner of Internal Revenue.

**No. 127.**

Argued Dec. 4, 5, 1934.

Decided Jan. 7, 1935.

*CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT*

Mr. Justice SUTHERLAND delivered the opinion of the Court.

Petitioner in 1928 was the owner of all the stock of United Mortgage Corporation. That corporation held among its assets 1,000 shares of the Monitor Securities Corporation. For the sole purpose of procuring a transfer of these shares to herself in order to sell them for her individual profit, and, at the same time, diminish the amount of income tax which would result from a direct transfer by way of dividend, she sought to bring about a 'reorganization' under section 112(g) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 816, 818, 26 USCA s 2112(g), set forth later in this opinion. To that end, she caused the Averill Corporation to be organized under the laws of Delaware on

September 18, 1928. Three days later, the United Mortgage Corporation transferred to the Averill Corporation the 1,000 shares of Monitor stock, for which all the shares of the Averill Corporation were issued to the petitioner. On September 24, the Averill Corporation was dissolved, and liquidated by distributing all its assets, namely, the Monitor shares, to the petitioner. No other business was ever transacted, or intended to be transacted, by that company. Petitioner immediately sold the Monitor shares for $133,333.33. She returned for taxation, as capital net gain, the sum of $76,007.88, based upon an apportioned cost of $57,325.45. Further details are unnecessary. It is not disputed that if the interposition of the so-called reorganization was ineffective, petitioner became liable for a much larger tax as a result of the transaction.

The Commissioner of Internal Revenue, being of opinion that the reorganization attempted was without substance and must be disregarded, held that petitioner was liable for a tax as though the United corporation had paid her a dividend consisting of the amount realized from the sale of the Monitor shares. In a proceeding before the Board of Tax Appeals, that body rejected the commissioner's view and upheld that of petitioner. 27 B.T.A. 223. Upon a review of the latter decision, the Circuit Court of Appeals sustained the commissioner and reversed the board, holding that there had been no 'reorganization' within the meaning of the statute. 69 F.(2d) 809. Petitioner

applied to this court for a writ of certiorari, which the government, considering the question one of importance, did not oppose. We granted the writ. 293 U.S. 538, 55 S.Ct. 82, 79 L.Ed. 645.

Section 112 of the Revenue Act of 1928 (26 USCA s 2112) deals with the subject of gain or loss resulting from the sale or exchange of property. Such gain or loss is to be recognized in computing the tax, except as provided in that section. The provisions of the section, so far as they are pertinent to the question here presented, follow:

> 'Sec. 112. * * * (g) Distribution of Stock on Reorganization. If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock of securities shall be recognized. * * *
>
> '(i) Definition of Reorganization. As used in this section * * *
>
> '(1) The term 'reorganization' means * * * (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of

> the corporation to which the assets are transferred. * * *

26 USCA s 2112(g), (i) (1).

It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing subdivision (B) is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that if a reorganization in reality was effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. United States v. Isham, 17 Wall. 496, 506, 21 L.Ed. 728; Superior Oil Co. v. Mississippi, 280 U.S. 390, 395, 396, 50 S.Ct. 169, 74 L.Ed. 504; Jones v. Helvering, 63 App.D.C. 204, 71 F.(2d) 214, 217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.

When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' (section 112(g) of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan

having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose-a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to

exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

Judgment affirmed.

**United States Court of Appeals for the Federal Circuit**

2008-5045

JADE TRADING, LLC, by and through, ROBERT W. ERVIN and LAURA KAVANAUGH ERVIN on behalf of ERVIN CAPITAL, LLC, Partners Other Than the Tax Matters Partner,

Plaintiffs-Appellants,

v.

UNITED STATES,

Defendant-Appellee.

David D. Aughtry, Chamberlain, Hrdlicka, White, Williams & Martin, of Atlanta, GA, argued for plaintiffs-appellants. With him on the brief were Nicolas F. Kory; and Linda S. Paine, of Houston, TX.

Joan I. Oppenheimer, Attorney, Appellate Section, Tax Division, United States Department of Justice, of Washington, DC, argued for defendant-appellee. With her on the brief were Gilbert S. Rothenberg, Acting Deputy Assistant Attorney General, and Richard Farber, Attorney.

Appealed from: United States Court of Federal Claims

Judge Mary Ellen Coster Williams

**United States Court of Appeals for the Federal Circuit**

2008-5045

JADE TRADING, LLC, by and through, ROBERT W. ERVIN and LAURA KAVANAUGH ERVIN on behalf of ERVIN CAPITAL, LLC, Partners Other Than the Tax Matters Partner,

Plaintiffs-Appellants,

v.

UNITED STATES,

Defendant-Appellee.

Appeal from the United States Court of Federal Claims in 03-CV-2164, Judge Mary Ellen Coster Williams

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DECIDED: March 23, 2010

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Before LOURIE, ARCHER, and LINN, Circuit Judges.

ARCHER, Circuit Judge.

JadeTrading, LLC ("Jade") appeals the Court of Federal Claims' denial of its petition for readjustment of the partnership items of Jade and its affirmance of the Internal Revenue Service's ("IRS" or "Service") application of penalties at the partnership level without consideration of the

partners' reasonable cause defense. Jade Trading v. United States, 80 Fed.Cl. 11 (2007). Because the contribution of euro call options to Jade (hereinafter sometimes called the spread transaction) was a transaction that lacked economic substance, we affirm the Court of Federal Claims' denial of Jade's petition. Further, we hold that the Court of Federal Claims lacked jurisdiction to review the application of penalties based on the outside bases of Jade's partners, and we therefore vacate that portion of the court's judgment and remand for further proceedings. We also vacate as moot the Court of Federal Claims' determination that Temp. Treas. Reg. §301.6221-1T(c), (d) is not invalid.

## I

### A

This case is governed by certain provisions of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). See 26 §§U.S.C. 6221-31 (1998).[1] Prior to TEFRA's enactment, tax liability adjustments of individual partners based on the operations of the partnership were rendered at the partner level. "TEFRA was intended, in relevant part, to prevent inconsistent and inequitable income tax treatment between various partners of the same partnership resulting from conflicting

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[1] Hereinafter, Title 26 U.S.C. is referred to as "the Tax Code."

determinations of partnership level items in individual partner proceedings." RJT Invs. X v. Comm'r Internal Revenue, 491 F.3d 732, 737 (8th Cir.2007). Under TEFRA, all "partnership items" are determined in a single proceeding. 26 U.S.C. §6221.[2] The results of this proceeding then apply to each individual partner's income tax return. If a partner wishes to challenge any adjustment to his income tax return or to assert any partner-level defenses, he may file a partner level refund suit. 26 U.S.C. §6230(c).

B

This case involves a tax shelter designed to produce large, artificial, i.e., noneconomic, losses for tax purposes. JadeTrading, 80 Fed.Cl. at 20. In general, the tax shelter here involved four steps: "1) Investment in Foreign Currency, 2) Contribution to a Partnership, 3) Partnership Investments, 4) Termination of Partnership Interests." Id. at 24-25 (describing tax opinion prepared for potential investors by BDO Seidman, a national accounting and tax consulting firm). The investor first simultaneously purchased a European-style call option and sold a

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[2] Section 6221 of the Tax Code states "[e]xcept as otherwise provided in this subchapter, the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level."

European-style call option.[3] Id. at 25. The investor next contributed the purchased and sold call options to a partnership. Id. The investor eventually exited the partnership, received an asset with a claimed high-basis and low-value, and then sold that asset in order to generate a tax loss. Id. A tax loss was anticipated because, at the time of the facts giving rise to this case, an investor's basis in a partnership was ordinarily not decreased by the amount of a contingent liability contributed to or assessed by a partnership. See Helmer v. Comm'r, 34 T.C.M. (CCH) 727 (1975) (holding that a contingent obligation, such as an option, was not a liability under §752 of the Tax Code because a partnership's obligation under the option does not become fixed until the option is exercised).[4]

C

The parties do not disagree with the basic facts found by the Court of Federal Claims. Therefore, we recite only those facts relevant to this decision.

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[3] An option is a contract that gives the buyer the right, but not the obligation, to buy or sell an asset at a predetermined price (the strike price). A European-style option is an option that can only be exercised on its expiration date.

[4] The sold call option contributed to the partnership in this case is similarly a contingent obligation that does not become fixed until it is exercised.

Robert W. Ervin and his two brothers were equal partners in a cable business, which they sold in 1999. The sale proceeds received in March 1999 resulted in a total gain to each brother of approximately $13,500,000. Because the buyer was a publicly traded company, the transaction was disclosed to the Securities Exchange Commission. Thereafter, the Ervins received numerous offers of investment and tax advice. After considering a number of these investment and tax proposals, the following transaction at issue here was entered into by the Ervin brothers.

In September 1999, the Ervin brothers each formed a single-member LLC. On September 15, 1999, each Ervin LLC entered into a separate master trading agreement with AIG, and each paid AIG an $84,100 "account opening fee" pursuant to this agreement. On September 29, 1999, each Ervin LLC purchased from AIG a call option on the euro at a strike price of 1.0840 ("purchased call option") for $15,000,020 and sold to AIG a call option on the euro at a strike price of 1.0850 ("sold call option") for $14,850,018. The options were all European-style options that expired on September 29, 2000, and had a face amount of 290,540,000 euros. Each Ervin LLC paid AIG only the difference in the premiums of the offsetting options, or $150,002.

On October 2, 1999, each Ervin LLC entered into a fifteen-month "consulting agreement" with New Vista, LLC (an affiliate of Sentinel Advisors,

LLC), which required each Ervin LLC to pay New Vista $750,000 for "consulting services." Payment of this fee was a prerequisite to the Ervin LLCs being admitted to the Jade partnership. Jade was formed by Sentinel and Banque Safra, a Luxembourg financial institution, on September 23, 1999, with Sentinel as the managing partner. On October 6, 1999, each Ervin LLC entered Jade as a partner. On that same day, each Ervin LLC contributed the above described euro call options to Jade, as well as $75,000 cash. In December 1999, each Ervin LLC withdrew from Jade. Each Ervin LLC's interest in assets distributed to it by Jade was valued at $126,122. The distributed assets consisted of Xerox stock, which was sold in 1999, and euros.

On its partnership return for 1999, Jade reported on its Schedule K (Partners' Shares of Income, Credits, Deductions, etc.) a loss of $292,015. Each of the Ervin brother's individual income tax return for 1999 claimed approximately $15 million in tax losses from his execution of the spread transaction and involvement in Jade. These tax losses resulted from each brother's increasing the basis of his interest in Jade ("outside basis") by the cost of the purchased call option ($15 million) and not decreasing this basis by the amount of the potential liability that Jade assumed under the sold call option.

After auditing the Jade partnership return, the IRS issued a final partnership administrative

adjustment ("FPAA") to Jade with respect to Jade's partnership items for the 1999 tax year. The FPAA determined that the Jade partnership should be disregarded and all transactions engaged in by Jade should be treated as being engaged in directly by the purported partners, including the Ervin LLCs. Thus, the FPAA disallowed the deductions claimed for losses purportedly incurred from the contribution of the spread transactions to Jade. The FPAA also disallowed the losses claimed by Jade and reduced Jade's claimed distributions of property to zero. The IRS also imposed accuracy-related penalties under §6662 of the Tax Code.

Subsequently, Jade filed a petition for readjustment of the partnership items of Jade in the Court of Federal Claims. The court upheld the IRS's determination, concluding that Jade had not met its burden of demonstrating that the contribution of the spread transactions to Jade objectively had economic substance. Jade Trading, 80 Fed.Cl. at 14. The court also affirmed the penalties determined by the IRS at the partnership level without considering the reasonable cause defenses that the partners might have. Id. at 60.

Jade appealed, and we have jurisdiction under 28 U.S.C. §1295(a)(3).

II

A

We review de novo the Court of Federal Claims' conclusion that the contribution of the spread transaction to Jade lacked economic substance. Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1357 (Fed.Cir.2006). However, we review the court's factual findings underlying this conclusion for clear error. SCS Hosp. Sys., Inc. v. Montefiore Hosp., 732 F.2d 1572, 1578 (Fed.Cir.1984). Finally, we review the court's jurisdictional determinations de novo. Distributed Solutions, Inc. v. United States, 539 F.3d 1340, 1343 (Fed.Cir.2008).

B

The Court of Federal Claims held that the Ervin LLCs' contributions of the spread transactions to Jade lacked economic substance. We agree.

The economic substance doctrine "require[s] disregarding, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality." Coltec, 454 F.3d at 1352. In Coltec we discussed the economic substance doctrine in detail, leaving no question as to its viability. We explained that the doctrine "represents a judicial effort to enforce the statutory purpose of the tax code." Id. at 1353. The doctrine, "[f]rom its inception, ... has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a

tax benefit." Id. at 1353-54. In Coltec, after examining cases from the Supreme Court, various courts of appeals, and our predecessor court, we concluded that the economic substance doctrine incorporated five general principles. Specifically, we opined that 1) the transaction cannot lack economic reality; 2) the taxpayer bears the burden of proving that the transaction has economic substance; 3) the economic substance of a transaction must be viewed objectively rather than subjectively; 4) the transaction to be analyzed is the one that gave rise to the alleged tax benefit; and 5) arrangements with subsidiaries that do not affect the economic interests of independent third parties deserve particularly close scrutiny. Id. at 1355-57. We also explained that "a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance." Id. at 1355.

The Ervin LLCs' transfer of the spread transactions to Jade lacked economic substance. The Ervin LLCs purchased euro call options from AIG for a premium of $15,000,020 and sold euro options to AIG for a premium of $14,850,018. However, the Ervin LLCs paid AIG only the difference-a net premium of $150,002. After contributing the spread transactions to Jade and subsequently exiting the partnership, the Ervins claimed a basis of over $15 million in their Jade interests by including only the cost of the purchased call option. As a result, the artificially

inflated basis generated a purported $14.9 million tax loss.

As the Court of Federal Claims noted, this loss was "purely fictional." JadeTrading, 80 Fed.Cl. at 45. Each Ervin LLC did not invest $15 million in the spread transaction contributed to Jade and did not lose almost $15 million upon exiting Jade. Neither option was, in fact, exercised. Thus, each Ervin LLC had a real loss of approximately $100,000 upon exiting Jade-the difference between its capital contribution of $225,000 to the Jade partnership and its redemption proceeds of $126,122 received from Jade.

Additionally, the formation of the Jade partnership appears to have had no economic purpose. The partnership did nothing to enhance the investment potential of the spread transaction. Id. at 46. However, for tax purposes, it was imperative that the individual partners contribute the spread transactions to Jade to generate the artificially inflated bases.

Also significant is the Court of Federal Claims' determination that the spread transaction was virtually guaranteed to be unprofitable. Each Ervin LLC was required to pay an $84,100 account opening fee to AIG and a $750,000 New Vista consulting fee.[5] Thus, each Ervin LLC spent at

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[5] In its findings, the Court of Federal Claims also included fees for an opinion letter prepared by Curtis Mallet. It is unclear whether each Ervin LLC was

least $834,100 for the chance at making a profit of $140,000.[6] No reasonable investor would engage in such a transaction to earn a profit. The Court of Federal Claims concluded, and we agree, that

> This transaction's fictional loss, inability to realize a profit, lack of investment character, meaningless inclusion in a partnership, and disproportionate tax advantage as compared to the amount invested and potential return, compel a conclusion that the spread transaction objectively lacked economic substance.

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"required" to purchase the $100,000 tax opinion letter. However, given that the letter was requested to cover "certain aspects of United States Federal income tax in connection with (i) investments in foreign currency that [the Ervins had] made and (ii) transactions in which [they] engaged with a partnership ... that trades in foreign currency," Jade Trading, 80 Fed.Cl. at 33, it is likely that the Ervins felt compelled to purchase the letter. The inclusion or absence of this fee does not change our analysis.

Additionally, the fees listed above do not include Sentinel's 2% management fee or its 20% incentive fee, or the 5% penalty for early withdrawal from Jade (which applied if the Ervin LLCs withdrew from Jade prior to 12 months from entering the partnership, which they did).

[6] This is calculated by subtracting the cost of each spread transaction ($150,002) from its maximum payoff ($290,540) that could occur due to the different option prices.

Id. at 14. As the Court of Federal Claims found, this spread transaction and its contribution to Jade "was developed as a tax avoidance mechanism and not as an investment strategy" by the BDO Seidman accounting firm. Id.

Jade argues that the contribution of the spread transactions to Jade had economic substance because the purchased call options and the sold call options were separate assets with separate documentation and were owned by unrelated parties. The Court of Federal Claims concluded that "the economic realities of the spread transaction contributed to Jade made it impossible to delink the option pairs," explaining:

> If the Ervin LLCs had wished to hold only the long position-that is, the option they purchased from AIG-they would have faced the prospect of theoretically unlimited gain.... To obtain that position, the Ervin LLCs would have been required to pay AIG the full face amount of the premium, about $15 million each, to purchase the options. Neither the Ervin LLCs nor Jade ever had sufficient funds to make such a payment. Moreover, under this scenario, the entire amount would have been at risk; had the euro not risen to 1.084, each Ervin LLC would have lost the entire $15 million premium it paid to AIG.
>
> Had the Ervin LLCs wished to hold on the short option sold to AIG, they would

> have faced the prospect of theoretically unlimited loss, as AIG would have benefitted in any rise of the euro above 1.085, not capped in any way. Because such a transaction would be uncovered, AIG would have had extensive credit concerns. The Ervin LLCs would not have received the premiums to which they would be theoretically entitled, because AIG would have retained those premium payments as margin, because AIG would not have had the spread's protection from loss. AIG would have required that the Ervins post margin in the amount of at least $8 million each. In sum, under the agreement with AIG, the Ervins could not separate the components of the spread without AIG's permission which would not likely have been forthcoming without the required margin.

Id. at 50-51 (citations to record omitted). As the government's expert explained, "[t]he spread strategy component options were priced together, purchased together, contributed to Jade together, and closed out by Jade together, and at no time during their lives did either the Ervin LLCs or Jade have the means to separate the component options." **[JA 5817]** The Court of Federal Claims concluded that "the transactions here cannot be separated because they were totally dependent on one another from an economic and pragmatic standpoint." Id. at 51. Jade has not persuaded us that this conclusion is in error.

Accordingly, we affirm the Court of Federal Claims' judgment that the contribution of the spread transactions to Jade lacked economic substance and should be disregarded for tax purposes.

C

Jade asserts that the Court of Federal Claims does not have jurisdiction to review the penalties imposed by the IRS based on the Ervins' outside bases in Jade.

Section 6226 of the Tax Code is TEFRA's judicial review provision. Specifically, §6226(f) grants the trial court (either the Court of Federal Claims or the United States Tax Court):

> jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

26 U.S.C. §6226(f) (emphases added).[7]

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[7] Under TEFRA, a "partnership item" is "any item required to be taken into account for the partnership's taxable year under any provision of subtitle A ... provided that ... such item is more appropriately determined at the partnership level than at the partner level." 26 U.S.C.

Jade contends that because the Ervins' outside bases in Jade, upon which the assessed penalties are based, are not partnership items, there could be no penalty applicable to a partnership item to trigger the court's penalty jurisdiction under §6226(f).

The government responds that while a partner's outside basis is an affected item and thus not itself a partnership item, most (if not all) of the components of a partner's outside basis are themselves partnership items. The government further argues that since all "legal and factual determinations that underlie the determination of the amount, timing, and characterization" of partnership items are themselves partnership items, the lack of economic substance of the spread transactions contributed to Jade is a partnership item.

In a factually analogous case, the D.C. Circuit considered whether §6226(f) conferred jurisdiction on the trial court, in that case the Tax Court, to determine that the partners had no outside bases in a partnership that was disregarded for tax purposes. Petaluma FX Partners, LLC. v. Comm'r

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§6231(a)(3). TEFRA further defines two other terms, namely, a "nonpartnership item" and an "affected item." A "nonpartnership item" is one that is not a "partnership item." 26 U.S.C. §6231(a)(4). And an "affected item" is one that is affected by a "partnership item." 26 U.S.C. §6231(a)5.

of Internal Revenue Serv., 591 F.3d 649 (D.C.Cir.2010). In Petaluma, the purported partnership, Petaluma, was formed with the purpose of engaging in foreign currency option trading. Id. at 650. The partners each contributed pairs of offsetting long and short foreign currency options to become partners in Petaluma. Id. The partners increased their adjusted bases in Petaluma to reflect the long options they contributed, but they did not reduce those bases to reflect Petaluma's assumption of their short options. Id. The partners subsequently withdrew from Petaluma, which fully liquidated their interest in the partnership by distributing cash and shares of Scient stock. Id. Prior to the end of the year, the partners sold their stock, taking their adjusted bases in the distributed stock equivalent to their adjusted bases in Petaluma immediately prior to the distribution. Id. Given the inflated adjusted bases in the stock, these sales created substantial short-term capital losses that the partners claimed on their federal tax returns. Id.

The parties' arguments on appeal in Petaluma were strikingly similar to those in this case. As in the present case, Petaluma argued that outside basis is an affected item, not a partnership item and, therefore, the Tax Court had no right to determine that its partners' outside bases were zero. Id. at 654. Also similar to this case, the government conceded that outside basis is not a partnership item but then argued that outside

basis is an affected item whose elements are largely or entirely partnership items. Id.

The D.C. Circuit agreed with Petaluma, stating that "the partners' outside bases are affected items, not partnership items. Unlike partnership items, affected items are determined not at the partnership level, but at the individual partner level." Id. The court observed that not only are partnership items and affected items treated at different levels, the assessment procedures are different. Id. at 655. In the case of a partnership item, the IRS may directly assess the tax against the individual partner by making a computational adjustment-applying the new tax treatment of all partnership items to the partner's return-and the partner must bring a refund claim to challenge the computation. 26 U.S.C. §6230(c)(1). However, if the partner's liability relates to affected items, the IRS must send a notice of deficiency to that partner, thereby initiating a deficiency proceeding against him individually. 26 U.S.C. §6230(a)(2)(A)(i); see Desmet v. Comm'r of Internal Rev., 581 F.3d 297, 302 (6th Cir.2009) (explaining that the IRS has different procedures for making adjustments to a partner's tax liability depending on whether the item is a partnership item or an affected item).

The court concluded that under §6226(f) the Tax Court did not have jurisdiction to review the determination that the individual partners had no outside basis in Petaluma. The court rejected the government's contention that, although an affected

item, outside basis could be determined in the partnership-level proceeding. "The fact that a determination seems obvious or easy does not expand the court's jurisdiction beyond what the statute provides. In other words, it does not matter how low the fruit hangs when one is forbidden to pick it." Id. at 655.

We find the D.C. Circuit's reasoning persuasive and see no reason to depart from it in this case. While the parties here are different, each of the Ervins' outside basis in Jade is an affected item and thus not determined at the partnership level. See Schell v. United States, 598 F.3d 1378, 1381-82 (Fed.Cir.2009) ("An example of an 'affected item' is a partner's tax basis in his partnership interest, which is affected by partnership items such as partnership income or loss."). We also agree with the D.C. Circuit's observation:

> [N]othing about the concept of outside basis indicates that it is more appropriately determined at the partnership level. If disregarding a partnership leads ineluctably to the conclusion that its partners have no outside basis, that should be just as obvious in partner-level proceedings as it is in partnership-level proceedings. Moreover, with the invalidity of the partnership conclusively established as a partnership-level determination, there is little danger that outside basis will receive

> inconsistent treatment at the individual partner level.

Petaluma, 591 F.3d at 655.

Because outside basis is not a "partnership item," we conclude that the Court of Federal Claims lacked jurisdiction to determine that the Ervins had no outside basis in Jade.

As explained above, under §6226(f), the trial court has jurisdiction over "the applicability of any penalty ... which relates to an adjustment to a partnership item." The penalty in this case was imposed on the underpayment of income tax due to the gross valuation misstatement of the partners' outside basis in the partnership. Outside basis is an affected item, not a partnership item; thus, the penalty here relates to an adjustment of an affected item, not a partnership item. Accordingly, the trial court did not have jurisdiction over the applicability of this particular penalty.

Because it is possible that at least some portion of the penalties could have been computed without relying on the partners' outside bases, we conclude that the penalty issue should be vacated and remanded. See id. at 655-56 (remanding for a determination as to whether some of the penalties could have been assessed without partner-level computations). Remand proceedings should determine whether any penalties could have been assessed without relying on the Ervins' outside bases.

D

Finally, Jade argues that the Court of Federal Claims should have considered the Ervin's reasonable cause defenses, asserting that Temp. Treas. Reg. §301.6221-1T(c), (d) is invalid. Because we vacate that portion of the Court of Federal Claims' judgment affirming the penalties assessed against the Ervins, the validity challenge to the temporary regulation is moot at this time, and we decline to reach it. See United States v. Alaska S.S. Co., 253 U.S. 113, 116, 40 S.Ct. 448, 64 L.Ed. 808 (1920) ("[I]t is a settled principle in this court that it will determine only actual matters in controversy essential to the decision of the particular case before it."); see also United States v. UPS Customhouse Brokerage, Inc. 575 F.3d 1376, 1383 (Fed.Cir.2009) (vacating as moot the issue of whether Customs could impose penalties aggregating more than $30,000 under 19 C.F.R. §111.91 when the case was being remanded for Customs to conduct a proper analysis of whether there was in fact a violation of 19 U.S.C. §1641); Elkem Metals Co. v. United States, 468 F.3d 795, 803 (Fed.Cir.2006) (concluding that because an amount was properly excluded from constructed value, the issue of whether the party correctly reported that amount was moot and need not be decided). While the Court of Federal Claims could conclude on remand that some of the penalties could have been assessed without relying on the Ervins' outside basis and thus putting this issue back into play, the opposite is also true. Although

these issues are important to the parties and may become relevant later in this case, deciding them now would be premature.

Accordingly, we vacate that portion of the Court of Federal Claims' judgment concluding that the Ervins' partner-level defenses cannot be brought at the partnership level.

III

Because the Court of Federal Claims correctly concluded that the contribution of the spread transactions to Jade lacked economic substance, we affirm the court's denial of Jade's petition for readjustment of partnership items. However, because the Court of Federal Claims lacked jurisdiction to review the penalties imposed on the underpayment of income tax due to the gross valuation misstatement of the Ervins' outside bases in Jade, we vacate that portion of the court's judgment affirming the penalties assessed against the Ervins. Additionally, we remand this issue for the court to determine whether any part of the penalties could have been assessed without relying on the Ervins' outside bases and thus falling within the court's jurisdiction. Finally, we vacate as moot that portion of the Court of Federal Claims' judgment upholding the validity of Temp. Treas. Reg. §301.6221-1T(c), (d).

**AFFIRMED-IN-PART, REVERSED-IN-PART, VACATED-IN-PART.**

COSTS

Each party shall bear its own costs.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term, 1999

(Argued: March 1, 2000 Decided: Aug. 17, 2000)

Docket No. 97-6215

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Joseph MONTI and Tita Monti,

Plaintiffs-Appellants,

-v.-

UNITED STATES OF AMERICA,

Defendant-Appellee.

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Before: McLAUGHLIN, SACK, and KATZMANN, Circuit Judges.

Appeal from a judgment of the United States District Court for the Eastern District of New York (Joanna Seybert, Judge) granting the government's motion to dismiss for lack of subject matter jurisdiction. We hold that the plaintiffs' action for a federal income tax refund is not attributable to a "partnership item" for purposes of the Tax Equity and Fiscal Responsibility Act of 1982 and that the district court therefore erred in ruling that it had no jurisdiction over the action.

Reversed and remanded.

JOHN W. HUGHES, New York, NY, for Plaintiffs-Appellants.

TERESA T. MILTON, Attorney, Tax Division, Department of Justice, Washington, DC (Loretta C. Argett, Assistant Attorney General, Washington, DC, and Teresa E. McLaughlin, Attorney, Tax Division, Department of Justice, Washington, DC, on the brief; Zachary W. Carter, then-United States Attorney for the Eastern District of New York, of counsel), for Defendant-Appellee.

SACK, Circuit Judge:

The question presented by this appeal is whether a partner's claim for tax treatment consistent with that accorded other partners in a settlement with the Internal Revenue Service is a claim for a refund attributable to a "nonpartnership item" that properly can be the subject of a suit in a federal district court, or is a claim for a refund attributable to a "partnership item" about which suit in federal district court is barred. We hold that it is attributable to a nonpartnership item and that this action asserting such a claim was therefore properly instituted in the district court.

Plaintiffs-Appellants Joseph and Tita Monti, a married couple, appeal from the dismissal of their federal income tax refund action by the United States District Court for the Eastern District of

New York (Joanna Seybert, Judge). The district court held that it lacked jurisdiction over the Montis' claim because the United States has not waived sovereign immunity for refund claims attributable to "partnership items" except in very limited circumstances not applicable to the Montis' case. We hold that a refund action based on the Internal Revenue Service's failure to offer consistent settlement terms to nonsettling partners of a partnership is not attributable to a "partnership item" for purposes of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub.L. No. 97-248, 96 Stat. 324, and that the United States has therefore waived sovereign immunity with respect to such an action. Accordingly, we reverse and remand the case to the district court for adjudication of the Montis' refund action on the merits.

## BACKGROUND

*Overview*

The Montis were limited partners in a partnership named Syn-Fuel Associates ("Syn-Fuel"). They claimed individual federal income tax deductions based on their partnership interests in Syn-Fuel for the years 1982 through 1985. In 1987 the Internal Revenue Service (the "IRS") audited Syn-Fuel pursuant to the provisions of TEFRA and, in a Final Partnership Administrative Adjustment ("FPAA"), disallowed many of the deductions. Syn-Fuel appealed the FPAA to the United States Tax Court, where it

was affirmed. See Peat Oil and Gas Assocs. v. Commissioner, 100 T.C. 271, 1993 WL 95582 (1993). This Court then affirmed the Tax Court's ruling in Ferguson v. Commissioner, 29 F.3d 98 (2d Cir.1994) (per curiam).

When the IRS enters into a settlement agreement regarding partnership taxes with one partner, it is required by TEFRA to "offer to any other partner who so requests[,] settlement terms ... which are consistent with those contained in [the] settlement agreement." I.R.C. §6224(c)(2). During the preparation of the FPAA and the subsequent litigation, many individual Syn-Fuel partners settled with the IRS. The Montis did not. The Montis' tax treatment was therefore resolved through the FPAA and the subsequent litigation. They have paid the taxes assessed to them according to the FPAA, but are now suing for a refund reflecting the consistent treatment that they assert is due to them.

In seeking a refund, the Montis allege that they were never given the statutorily required notice of the terms of one of the settlements entered into by several limited partners (the "Craig Settlement"), that the time during which they were required to file for treatment equivalent to that given to other Syn-Fuel partners under the Craig Settlement therefore never began to run, and that their current request for settlement terms consistent with the Craig Settlement therefore remains timely. The terms of the Craig Settlement are far

more favorable to the Montis than those resulting from the FPAA and the subsequent related litigation.

Sovereign Immunity

The doctrine of sovereign immunity prevents suits against the United States unless the United States has waived the immunity. See United States v. Testan, 424 U.S. 392, 399, 96 S.Ct. 948, 47 L.Ed.2d 114 (1976). The government has done so broadly with respect to federal income tax refund actions. See 28 U.S.C. §1346(a)(1); United States v. Forma, 42 F.3d 759, 763 (2d Cir.1994). There are certain kinds of refund actions, however, with respect to which the government has not waived sovereign immunity. Relevant here: "No action may be brought for a refund attributable to partnership items (as defined in [I.R.C.] section 6231(a)(3)) except as provided in section 6228(b) or section 6230(c)." I.R.C. §7422(h). Thus, if the refund the Montis seek is attributable to a partnership item other than those excepted by the statute, their action was correctly dismissed by the district court.

Statutory Framework Under TEFRA

Partnerships are generally not taxable entities. "[T]he income and expenses of the partnership normally 'flow through' to the several partners, who remain ultimately responsible for filing their own taxes." Transpac Drilling Venture 1982-12 v. Commissioner, 147 F.3d 221, 223 (2d Cir.1998).

Until the enactment of TEFRA in 1982, administrative and judicial proceedings related to partnership income were therefore conducted at the level of the individual partner. If the IRS took issue with the partnership's books or returns, it addressed the issue with each partner individually. See Chimblo v. Commissioner, 177 F.3d 119, 121 (2d Cir.1999).

Because this system proved inefficient and often led to inconsistent results, "[u]nder TEFRA, one proceeding determines how partnership items will be reported on all of the partners' individual returns. The statute requires partners, on their personal returns, to treat partnership items consistently with the items' treatment on the partnership return." Olson v. United States, 37 Fed. Cl. 727, 731 (1997), aff'd, 172 F.3d 1311 (Fed.Cir.1999). Individual taxpayers still pay the relevant taxes--the partnership does not pay income tax--but determinations as to the amount of tax attributable to partnership items are made at the partnership level. See Randell v. United States, 64 F.3d 101, 103-04 (2d Cir.1995), cert. denied, 519 U.S. 815, 117 S.Ct. 65, 136 L.Ed.2d 26 (1996).

TEFRA defines a partnership item as follows:

> The term "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the

> Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

I.R.C. §6231(a)(3). A "nonpartnership item" is defined as "an item which is (or is treated as) not a partnership item." I.R.C. §6231(a)(4).

If the IRS decides to examine a partnership's tax return, each partner can opt either to participate in the proceeding or seek to settle. Absent a settlement with all the partners, the proceeding results in an FPAA that must be sent to the partnership's Tax Matters Partner ("TMP") and to all "notice partners" who, because of the magnitude of their interest in the partnership are, by statute, entitled to direct notice from the IRS. See I.R.C. §6223(a)(2). The TMP is responsible for notifying non-notice partners, such as the Montis, of the FPAA. The FPAA may then be appealed by the TMP or any notice partner to the Tax Court, a federal district court, or the Court of Claims, see Chimblo, 177 F.3d at 121, with all other partners who have not settled being treated as parties to such an action, see I.R.C. §6226(c). Unless a partner has opted out of the FPAA process by settling, that partner is bound by the results of this process. Because the FPAA determines the tax treatment of partnership items, a partner cannot bring a refund action attributable to anything litigated during the FPAA process. Allowing such lawsuits would undercut TEFRA's goal of

consolidating the treatment of partnership items at the partnership level. See Kaplan v. United States, 133 F.3d 469, 473 (7th Cir. 1998) ("TEFRA requires that all challenges to adjustments of partnership items be made in a single, unified agency proceeding; indeed, this is the key component of TEFRA that yields the desired benefits of economy and consistency.").[1]

A partner who settles with the IRS under I.R.C. §6224(b) thereby removes him or herself from the partnership-level FPAA proceedings. But the Internal Revenue Code provides that if the IRS enters into such a settlement with one or more partners, it is required to "offer to any other partner who so requests [,] settlement terms ... which are consistent with those contained in [the] settlement agreement." I.R.C. §6224(c)(2). In other

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[1] By statute, a partner may bring suit for a refund attributable to a partnership item, however, if "the Secretary failed to allow a credit or to make a refund to the partner in the amount of the overpayment attributable to the application to the partner of a settlement", I.R.C. §6230(c)(1)(B), or if the partner's request for an administrative adjustment is denied, see I.R.C. §6228(b). These suits are permitted because the issue of how the partnership's tax status applies to a particular partner will vary from partner to partner. If the IRS makes a computational mistake when applying the FPAA to an individual partner, or denies a partner's request for an adjustment, allowing that partner to sue for a refund is thus consistent with the goals of TEFRA. See Kaplan, 133 F.3d at 472-73.

words, the IRS cannot play favorites; if one partner settles, it must offer the same settlement terms to all partners. If the IRS does settle the tax liability of a partner it must, under Tax Court Rule 248(c)(2), serve notice of the settlement on the partnership's TMP within seven days of executing the agreement. The TMP is then responsible for notifying the other partners of the settlement. See I.R.C. §6223(g); 26 C.F.R. §301.6223(g) 1T(b)(1)(iv) Thereafter, any partner may request settlement terms consistent with those accorded to the settling partner or partners at any time before the "later of--(i) The 150th day after the day on which the notice of final partnership administrative adjustment is mailed to the tax matters partner, or (ii) The 60th day after the day on which the settlement agreement was entered into." 26 C.F.R. §301.6224(c)-3T(c)(3). When a partner settles with the IRS with respect to an item, that item ceases to be a "partnership item" and becomes a "nonpartnership item" with respect to the settling partner. See I.R.C. §6231(b)(1)(C).

Factual Background

The Montis acquired their partnership interest in Syn-Fuel in 1982. They claimed deductions of between $200,000 and $245,000 on each of their 1982, 1983, 1984 and 1985 joint tax returns. The IRS audited Syn-Fuel in 1987. It disallowed the deductions Syn-Fuel had claimed and which its partners had correspondingly claimed on their own behalf. On March 11, 1988, the IRS issued an

FPAA outlining the tax treatment that would be accorded to the partnership. On August 2, 1988, Syn-Fuel's TMP appealed the FPAA to the Tax Court.

In mid-1992, Dennis Brager, a lawyer who represented the Montis and some of the other Syn-Fuel partners in their Syn-Fuel dealings, negotiated the Craig Settlement on behalf of other Syn-Fuel partners with Lawrence Dorr, the IRS Appeals Officer assigned to the case. Although negotiations for the Craig Settlement were completed in mid-1992, the settling partners did not formally enter into it until December 1992. Under Tax Court Rule 248(c)(2), the IRS had seven days thereafter in which to notify Syn-Fuel's TMP of the Craig Settlement. The IRS failed to do so. Indeed, the IRS did not formally notify anyone about the settlement until March 10, 1993, when it sent a letter to Brager and the Syn-Fuel TMP stating that the Craig Settlement had been consummated seventy days earlier, on December 31, 1992.

After receiving the March 10, 1993 letter notifying his clients of the Craig Settlement, Brager had a conversation with Dorr. Dorr told Brager that Brager's clients, other than those who were part of the Craig Settlement, had only sixty days after the date of the Craig Settlement to request consistent terms, and that those sixty days had expired on or about March 1, 1993--sixty days after December 31, 1992 and nine days before

Dorr's letter to Brager officially noting the fact of the settlement. The IRS thus took the position that the Montis' period for requesting consistent terms had ended nine days before they were notified through their counsel or the TMP that it had begun.

On April 1, 1993, the Tax Court upheld the FPAA, see Peat Oil and Gas Assocs. v. Commissioner, 100 T.C. 271, 1993 WL 95582 (1993), making the terms of the Craig Settlement, which were more favorable to partners than were the terms of the FPAA, attractive to non-settling partners such as the Montis. On April 30, 1993, Brager therefore wrote to his clients advising them that although the IRS had taken the position that the period for requesting terms consistent with the Craig Settlement was over, he personally believed that all Syn-Fuel partners were entitled to consistent terms and recommended that they request them. Brager included a form for requesting consistent terms with his letter and instructed his clients to fill it out by May 10, 1993, which he figured would be sixty days after March 10, 1993, the date of the IRS letter formally giving notice of the Craig Settlement. Brager made this recommendation despite the fact that the IRS's stated position was that any requests received after March 1, 1993 would be untimely. The Montis did not execute the form requesting consistent terms.

On June 10, 1993, Dorr wrote another letter to Brager. He confirmed his earlier position but said that "in the interest of fairness" the IRS would accept requests for consistent terms received within sixty days of the March 10 letter. But by the time of the June 10 letter, that period had also expired. In other words, the IRS was saying on June 10 that in the interest of "fairness" the Montis would have until May 10 to request consistent terms. Only those partners who had followed Brager's advice and ignored the IRS's earlier statements would thus be entitled to consistent terms. The Montis and any partners similarly situated were, as far as the IRS was concerned, out of luck.

Nearly a year later, on May 20, 1994, this Court affirmed the Tax Court's decision finalizing the FPAA's treatment of Syn-Fuel partnership items. See Ferguson v. Commissioner, 29 F.3d 98 (2d Cir.1994) (per curiam). On June 28, 1994, the IRS therefore sent the Montis a notice of computational adjustment informing them how much they owed in back taxes as a result of the partnership's tax treatment under the FPAA.

Five months later, on December 2, 1994, the Montis finally requested settlement terms consistent with the Craig Settlement and simultaneously paid all the back taxes assessed against them by the IRS as a result of the FPAA proceedings. They then claimed refunds for the amounts paid beyond what they would have had to

pay under the terms of the Craig Settlement. On December 9, 1994, the IRS denied the Montis' request for consistent terms on the ground that their request was untimely because it had been filed more than sixty days after the execution of the Craig Settlement.

Having been turned down for consistent treatment by the IRS, the Montis brought the current refund action in the United States District Court for the Eastern District of New York. The government moved to dismiss, arguing that because the action was for a refund "attributable to partnership items" under I.R.C. §7422(h) that did not fall within the exception for overpayments "attributable to the application ... of a settlement" under I.R.C. §6230(c)(1)(B), the United States had not waived sovereign immunity with respect to the suit. The district court agreed and dismissed the action for lack of subject matter jurisdiction. See Monti v. U.S., 976 F.Supp. 157 (E.D.N.Y.1997).

On appeal, the Montis argue that the denial of their statutory right to request consistent terms is not a partnership item and that the refund they seek is therefore not attributable to a partnership item. In the alternative, they argue that if their right to request consistent terms is a partnership item their refund is nevertheless one "attributable to the application ... of a settlement" to them. They further assert that we should grant summary judgment in their favor because neither they nor the TMP has ever received notice of a sixty-day

period in which to request consistent terms. Because such a sixty-day period has not begun to run, they argue, they are entitled, as a matter of law, to terms consistent with those contained in the Craig Settlement.

## DISCUSSION

### I. Standard of Review

The issue that we decide on this appeal, whether the complaint was properly dismissed pursuant to Fed.R.Civ.P. 12(b)(1) because the United States has not waived sovereign immunity with respect to the claim asserted, is one of pure statutory interpretation. We therefore review the decision of the district court de novo. See Up State Fed. Credit Union v. Walker, 198 F.3d 372, 374 (2d Cir.1999).

### II. Is the Claim Attributable to a Partnership Item?

The Montis argue that they had a right to settlement terms consistent with those in the Craig Settlement. The IRS denied them that right, they assert, by initially failing to give them notice of the Craig Settlement and by subsequently telling them that their time for requesting consistent terms had expired. They argue that their claim that they were deprived of their right to consistent terms is not attributable to a partnership item because a decision on that issue depends on facts unique to them and unconnected with the resolution of partnership-wide issues.

They conclude that because the refund they seek is attributable to this nonpartnership item the district court had jurisdiction over their claims. We agree.

Partnership items are those "more appropriately determined at the partnership level than at the partner level." I.R.C. §6231(a)(3). Since the question of whether a particular partner has properly been offered and is entitled to consistent terms depends on facts specific to that partner and his or her dealings with the IRS, there is no apparent reason why determination of the item is "more appropriate[ ]" at the partnership level.

Moreover, "[t]he items ... more appropriately determined at the partnership level" are set forth in the regulations implementing TEFRA. See 26C.F.R. §301.6231(a)(3)-1 They include the income, gains, losses, deductions, and credits of the partnership, and distributions received and contributions made by it. See id. The right of individual partners to request consistent settlement terms, as provided for in I.R.C. §6224(c)(2), is not on the list.

Finally, under TEFRA, a partnership item is "any item required to be taken into account for the partnership's taxable year under any provision of subtitle A [of the Internal Revenue Code]." I.R.C. §6231(a)(3). A partner's right to consistent settlement terms is located in subtitle F.

The alleged deprivation of the Montis' right to consistent terms is thus not a partnership item. Their claim for a refund is attributable to this nonpartnership item, not a partnership item, such as the amount of income of or the propriety of deductions taken by Syn-Fuel.

At some level of generality, of course, most refund actions involving the taxation of a partnership can be described as seeking a refund "attributable to partnership items," I.R.C. §7422(h). In the absence of partnership income or loss, both partnership items, there would be no taxes in the first place; in the absence of claimed partnership deductions, perhaps no FPAA. But such a reading of the phrase "attributable to partnership items" would make most or all refund claims arising out of the taxation of partnerships, even those entirely about and entirely dependent on facts peculiar to a single partner, claims for refunds "attributable to partnership items." To blur or erase in that manner the distinction between proceedings involving partnership items and those involving nonpartnership items would be contrary to the system of separate treatment of partnership and nonpartnership issues Congress established by enacting TEFRA.

The Internal Revenue Code provides that with exceptions not relevant to this issue, "no action may be brought for a refund attributable to partnership items." I.R.C. §7422(h). We conclude that the Montis' action is not "for a refund

attributable to partnership items" and therefore may be brought in federal district court.

### III. The Opinion of the District Court

The district court held that the right to consistent settlement terms is a partnership item. See Monti, 976 F.Supp. at 161-62. Its reasons for doing so are unpersuasive.

First, as the district court observed, I.R.C. §6224(c)(2) does refer to a partner's right to enter into an agreement consistent with the terms of a settlement made "with respect to partnership items." See id. at 161. But it does not follow, as the district court held, that the §6224(c)(2) right is itself a partnership item. The §6224(c)(2) right is an individual right to consistent terms. One partner's right to settlement terms consistent with those granted to another partner is not a partnership item, because the question posed requires consideration of the relationship between one partner's situation and another's and the individual's, rather than the partnership's, communications with the IRS. The facts needed to determine whether consistent terms were offered are facts about the partner, not facts about the partnership.

Second, the district court acknowledged that settlement agreements differ from partner to partner but reasoned that that does not indicate the involvement of a nonpartnership item because "at the partnership level proceeding, [too,] each

partner will owe a different amount in taxes based on [his or her] pro rata share of the partnership." Monti, 976 F.Supp. at 161. But at the partnership-level proceeding, determinations are made as to the tax treatment of partnership items; that treatment is then applied to the partners on a partner-by-partner basis depending on the interest of each in the partnership. Determinations as to whether individual partners received proper notice are not made on a partnership basis and then applied to individual partners. They are made on a partner-by-partner basis.

Third, the district court feared that allowing partners to settle "outside the partnership level would ... undermine the consistency and uniformity of resolving all the partners['] claims of partnership items together." Id. at 162. But whenever the IRS settles with an individual partner, that partner is treated differently than the partners who choose not to settle. That does not undercut TEFRA's uniformity goal. The statute creates a system under which all partnership items are resolved in a single proceeding unless a partner settles with the IRS and thereby withdraws from the proceeding. The fact that individual partners may be given the opportunity to withdraw from the FPAA process is not inconsistent with the principle that partnership items are to be treated uniformly in the process.

Nor do plaintiffs like the Montis get "an unlimited number of bites at the apple," as the

district court concluded, id. at 162 n. 2, if the right to consistent terms is a nonpartnership item. If the IRS had simply fulfilled the requirement that it give partners timely notice of settlement, the Montis would have been compelled to decide within a specified time period either to request treatment consistent with the Craig Settlement terms or be bound by the FPAA. It was the IRS's alleged failure to give notice before the conclusion of the FPAA and the litigation that confirmed it that had the effect of allowing the Montis to track the FPAA litigation and compare its results to the terms of the Craig Settlement before choosing whether to request consistent treatment. True, in this case the Montis may be allowed to place a bet on a race that has already been run, but that is only because the IRS never bothered to announce last call.

**IV. The Prochorenko Litigation**

Finally, we take note of another lawsuit stemming from the Syn-Fuel FPAA and the Craig Settlement that also involved Brager clients. See Prochorenko v. United States, 45 Fed. Cl. 494 (2000). A set of Syn-Fuel partners, a married couple named Collitti, made a claim strikingly similar to the Montis' claim here: On the basis of facts peculiar to them, the Collittis asserted that they were entitled to terms consistent with the Craig Settlement. Instead of litigating their claim to judgment as did the Montis, however, the Collittis settled it with the IRS on terms similar to those contained in the Craig Settlement. See id. at

497. In 1997, yet another couple of Syn-Fuel partners, the Prochorenkos, learned of the IRS's agreement with the Collittis and sought consistent treatment, not with the Craig Settlement, but with the Collitti settlement. See id.

The IRS argued that the Prochorenkos were not entitled to treatment consistent with the Collitti settlement because (i) partners are only entitled to terms consistent with those contained in "a settlement agreement ... with respect to partnership items," I.R.C. §6224(c)(2), and (ii) the settlement of the Collittis' claim for consistent treatment was not a "settlement agreement ... with respect to partnership items." In support of these propositions, the IRS asserted that

> [a] dispute over whether there is a right to consistent terms [i.e., the Collittis's dispute with the IRS] is not a dispute over a "partnership item" because each partner's claim would depend upon facts peculiar to that partner-- e.g., whether that partner had made a timely request for an offer of consistent terms.

The Court of Claims, ruling in favor the IRS, agreed. See id.

The argument made by the IRS in *Prochorenko* is difficult to square with the argument made by the IRS here. Both the Collittis and the Montis had what the IRS described in the Prochorenko litigation as "a dispute [with the IRS] over whether

[they have] a right to [terms] consistent" with the Craig Agreement. If the Collittis' settlement of that dispute was not a settlement "with respect to partnership items," I.R.C. §6224(c)(2), then it would appear that the Montis' attempt to resolve a virtually identical dispute in court is not an action for "a refund attributable to partnership items", I.R.C. §7422(h). There is a difference, of course, between the words "with respect to partnership items" and the words "attributable to partnership items," but we fail to see any significance in that difference here. The Court of Claims's conclusion that the Collittis' settlement of their claim for treatment consistent with the Craig Settlement was not a settlement "with respect to partnership items" thus reinforces our conclusion that the Montis' claim for treatment consistent with the Craig Settlement was not made in an action for "a refund attributable to partnership items."

**V. Summary Judgment**

The parties each claim that if the district court had subject matter jurisdiction, as we now hold that it did, they are entitled to summary judgment. Because it granted the government's motion to dismiss, the district court never reached that issue. We think it the better course for the district court to decide the issue on a complete record and full briefing rather than for us to do so in the first instance. See Aardwoolf Corp. v. Nelson Capital

Corp., 861 F.2d 46, 49 (2d Cir.1988). We remand the case to the district court for that purpose.

## CONCLUSION

The logic of deeming a dispute over the right to consistent terms a dispute over a nonpartnership item is compelling.

> Because the purpose of [I.R.C.] section 7422(h) [depriving federal district courts of subject matter jurisdiction in tax refund suits attributable to partnership items] is evidently to prevent an individual partner's refund action from interfering with the partnership level determination of partnership items, that bar becomes unnecessary when the partnership level proceeding has in some sense concluded.

Alexander v. United States, 44 F.3d 328, 331 (5th Cir.1995). The Montis' request for terms consistent with the Craig Settlement would not "interfer[e] with the partnership level determination of partnership terms." Id. They do not seek to relitigate, or renegotiate, the tax treatment of any partnership items. They want only to argue that their request for consistent settlement terms was timely because they never received adequate or timely notice. That is not an issue that can be resolved at the partnership level.

For the foregoing reasons, we reverse the district court's judgment dismissing this action for want of subject matter jurisdiction and remand for

the district court to entertain and decide the parties' cross- motions for summary judgment on the merits.

**United States Court of Appeals for the District of Columbia Circuit.**

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Argued September 24, 2009

Decided January 12, 2010

No. 08-1356

PETALUMA FX PARTNERS, LLC AND RONALD SCOTT VANDERBEEK, A PARTNER OTHER THAN THE TAX MATTERS PARTNER, APPELLANTS

v.

COMMISSIONER OF INTERNAL REVENUE SERVICE, APPELLEE

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Appeal from the United States Tax Court

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*Edward M. Robbins Jr.* argued the cause and filed the briefs for appellants.

*Sheldon M. Kay*, *Thomas A. Cullinan*, and *Julie P. Bowling* were on the brief for *amicus curiae* AJF-1, LLC in support of appellants.

*Joan I. Oppenheimer*, Attorney, U.S. Department of Justice, argued the cause for appellee. With her on the brief were *Gilbert S. Rothenberg*, Acting Deputy Assistant Attorney General, and *Richard Farber*, Supervisory

Attorney. *Judith A. Hagley*, Attorney, entered an appearance.

Before: SENTELLE, *Chief Judge*, and GRIFFITH and KAVANAUGH, *Circuit Judges*.

Opinion for the Court filed by *Chief Judge* SENTELLE.

SENTELLE, Chief Judge: Petaluma FX Partners, LLC appeals from the Tax Court's decision that it had jurisdiction over several partnership-level determinations and that valuation misstatement penalties applied. Specifically, the Tax Court held that it had jurisdiction to determine that Petaluma was a sham, lacked economic substance, and should be disregarded for tax purposes; that Petaluma's partners had no outside basis in the disregarded partnership; and that the gross valuation misstatement penalty applied. *Petaluma FX Partners, LLC v. Comm'r,* 131 T.C. 9, 2008 WL 4682543 (U.S.Tax Ct. Oct.23, 2008). For the reasons explained below, we affirm the Tax Court's holding that it had jurisdiction to determine that Petaluma was a sham and should be disregarded for tax purposes, but reverse its holding that it had jurisdiction to determine that Petaluma's partners had no outside basis in the partnership. In addition, we set aside the Tax Court's holding that it had jurisdiction to determine whether accuracy-related penalties applied and that the valuation misstatement penalties did apply in this case.

## I. Background

### A. Factual Background

This case involves a "Son of BOSS" tax shelter. Like many of its kin, this tax shelter employs a series of transactions to create artificial financial losses that are used to offset real financial gains, thereby reducing tax liability. In 2000, the Internal Revenue Service ("IRS") identified Son of BOSS tax shelters as abusive transactions. I.R.S. Notice 2000-44, 2000-2 C.B. 255; *see also Desmet v. Comm'r,* 581 F.3d 297, 299 (6th Cir.2009). The facts of this case illustrate how this shelter works. We rely primarily on the Tax Court's description of the facts, which is undisputed. *Petaluma,* 2008 WL 4682543, at * 1-3. Petaluma, a purported partnership, was formed on August 18, 2000. Its ostensible purpose was to engage in foreign currency option trading. On October 10, 2000, Ronald Thomas Vanderbeek and Ronald Scott Vanderbeek (collectively, "the Vanderbeeks") each contributed pairs of offsetting long and short foreign currency options to become partners of Petaluma. The Vanderbeeks increased their adjusted bases in Petaluma to reflect the long options they contributed, but did not reduce those bases to reflect Petaluma's assumption of their short options. On December 12, 2000, the Vanderbeeks withdrew from Petaluma, which fully liquidated their interests in the partnership by

distributing cash and shares of Scient stock[1] to them. In keeping with 26 U.S.C. §732(b), they took adjusted bases in the distributed stock equivalent to their adjusted bases in Petaluma immediately prior to the distribution. On December 26, 2000, the Vanderbeeks sold their Scient stock. Given their inflated adjusted bases in the stock, these sales created substantial short-term capital losses that the Vanderbeeks subsequently claimed on their 2000 federal income tax returns. For example, Ronald Thomas Vanderbeek sold his Scient stock for $122,528 and claimed a short-term capital loss of $17,776,360, which conveniently offset $14,472,420 in longterm capital gains. Likewise, Ronald Scott Vanderbeek sold his Scient stock for $39,410 and claimed a resulting short-term capital loss of $7,631,542, thereby offsetting long-term capital gains of $6,191,778.

**B. Statutory Background**

Although partnerships do not pay federal income taxes, they must file annual informational returns reporting income, loss, deductions, and credits. 26 U.S.C. §§701, 6031(a); Treas. Reg. §301.6231(a)(3)-1(a)(1)(i). The partners are then responsible for reporting their distributive shares of the partnership's income or loss on their individual federal income tax returns. 26 U.S.C. §§701-702, 704. Congress established the current

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[1] The stock is not further identified in the parties' submissions.

framework for adjudicating partnership-related tax matters in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub.L. No. 97-248, §402, 96 Stat. 324, 648-67 (codified as amended at 26 U.S.C. §§6221-6232). Prior to TEFRA, all partnership items were determined at the individual taxpayer level, which often required duplicative proceedings for different partners and sometimes resulted in inconsistent treatment of partnership items from partner to partner. Under TEFRA, partnership items are now determined in unified partnership-level audit and judicial proceedings. 26 U.S.C. §6221. When the IRS disagrees with how a partnership return reports partnership items, it may commence an administrative proceeding by issuing a notice of final partnership administrative adjustment ("FPAA") to the partners. §6223(a), (d). Once an FPAA is mailed, the partnership's tax matters partner has 90 days to file a petition for readjustment of partnership items. §6226(a). If the tax matters partner does not file within that period, any other partner who received the FPAA has an additional 60 days to file a petition. §6226(b)(1). Once a petition has been filed, the reviewing court has jurisdiction to determine all partnership items for the partnership taxable year addressed by the FPAA. §6226(f).

**C. The FPAA and the Tax Court's Decision**

On April 2, 2001, Petaluma filed a Form 1065 partnership return for its 2000 taxable year. The

Commissioner issued an FPAA to the Petaluma partners on July 28, 2005. The FPAA disallowed all partnership items reported on Petaluma's return, reducing them from the amount Petaluma originally claimed to zero. The FPAA also listed "Outside Partnership Basis," which was not originally reported on Petaluma's partnership return, and reduced its value from $24,943,505 to $0. In addition, it included a section titled "EXHIBIT A-Explanation of Items," which determined that Petaluma's existence as a partnership had not been established, that it was formed solely for tax avoidance, that it was a sham and lacked economic substance, and that it should therefore be disregarded for tax purposes. The Explanation also determined that Petaluma's partners "have not established adjusted bases in their respective partnership interests in an amount greater than zero." Finally, the Explanation determined that various accuracy-related penalties set forth in 26 U.S.C. §6662(a) applied to all underpayments of tax attributable to these adjustments. On December 30, 2005, Ronald Scott Vanderbeek, a Petaluma partner who was not the tax matters partner, filed a petition for readjustment with the Tax Court.

In the Tax Court, Petaluma and the Commissioner entered a settlement of stipulated issues in which Petaluma conceded that the reduction of the line items in its partnership return to zero was appropriate. Petaluma retained just two arguments-first, that the Tax Court lacked

jurisdiction to consider certain issues in the FPAA, and second, that the valuation misstatement penalties did not apply. Both parties moved for summary judgment, and the Tax Court granted summary judgment for the Commissioner on October 23, 2008.

In its opinion, the Tax Court first held that it had jurisdiction to determine whether Petaluma should be disregarded for tax purposes. It reasoned that "the determination whether Petaluma is a sham, lacks economic substance, or otherwise should be disregarded for tax purposes is a partnership item over which we have jurisdiction." *Petaluma,* 2008 WL 4682543, at *9. Second, it held that because Petaluma had been disregarded for tax purposes, the court had jurisdiction to determine that the partners' outside bases in the partnership were zero because "there can be no adjusted basis in a disregarded partnership." *Id.* at *10. Third, the court held that it had jurisdiction over the accuracy-related penalties because §6226(f) gave it jurisdiction to determine "the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item." *Id.* at *11-12 (quoting 26 U.S.C. §6226(f)). Fourth, the court held that "the gross valuation [misstatement] penalty applies when the adjusted basis of property is reduced to zero because a transaction was disregarded as a sham or lacking economic substance and the taxpayer claims an adjusted basis in the property

of a greater amount." *Id.* at * 14. Petaluma timely appealed.

## II. Analysis

### A. Jurisdiction and Standard of Review

Petaluma filed a petition for readjustment of partnership items with the Tax Court under 26 U.S.C. §6226. The Tax Court's decisions concerning such petitions are generally reviewed by the U.S. Court of Appeals for the circuit in which the partnership's principal place of business is located. §7482(b)(1)(E). When a partnership has no principal place of business, as is the case here, the Tax Court's decision "may be reviewed by the Court of Appeals for the District of Columbia." §7482(b)(1). We review the Tax Court's decisions "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury." §7482(a)(1). Since the facts of this case are undisputed, we review the questions of law it presents de novo. *Andantech L.L.C. v. Comm'r,* 331 F.3d 972, 976 (D.C.Cir.2003).

### B. Disregarding the Partnership

Petaluma contends that the Tax Court erred in holding that it had jurisdiction to determine that the partnership was a sham, lacked economic substance, and should be disregarded for tax purposes. Under TEFRA, a court considering a petition for readjustment has "jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the

notice of final partnership administrative adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item." 26 U.S.C. §6226(f). Petaluma argues that the Tax Court had no jurisdiction to determine that it was a sham and lacked economic purpose because that determination was not a "partnership item" within the meaning of §6226(f). We disagree.

**(1) Section 6233**

The jurisdiction of the Tax Court over this case is governed by 26 U.S.C. §6233. That section addresses instances in which a partnership return is filed, but the purported partnership either does not exist or is not actually a partnership. In those situations, §6233 mandates that TEFRA's provisions still apply "to the extent provided in regulations." *Id.* The relevant regulations state that "[a]ny final partnership administrative adjustment or judicial determination ... may include a determination that the entity is not a partnership for such taxable year." Temp. Treas. Reg. §301.6233-1T(a). Under the statutory authority of §6233, this regulation explicitly authorized the Tax Court to determine that Petaluma was not a partnership for the 2000 taxable year.

### (2) Partnership Items

The next question raised by Petaluma's argument is whether the sham determination was a partnership item. The Internal Revenue Code states that "partnership item" means "any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level." 26 U.S.C. §6231(a)(3). Thus a partnership item must be (1) "required to be taken into account ... under any provision of subtitle A" and (2) identified by regulation as "more appropriately determined at the partnership level." *Id.* We conclude that the determination that Petaluma was not a valid partnership meets both elements of this test.

#### (a) Required to Be Taken into Account Under Subtitle A

For the validity of a partnership to be a partnership item, it must be "required to be taken into account ... under any provision of subtitle A," which is the subtitle concerning income taxes. We have little difficulty concluding that application of the income tax provisions of Subtitle A to the tax liability of a taxpayer who receives income from a purported partnership entails a determination of the validity of that partnership. As the Eighth Circuit has stated, "When filling out individual tax

returns, the very process of calculating an outside basis, reporting a sales price, and claiming a capital loss following a partnership liquidation presupposes that the partnership was valid." *RJT Investments X v. Comm'r,* 491 F.3d 732, 736 (8th Cir.2007). Thus the first requirement of the test is met.

### (b) More Appropriately Determined at the Partnership Level

In arguing that the second requirement is not met, Petaluma urges that the term "item" should be interpreted narrowly, arguing that it only includes accounting elements such as income, deductions, credit, gain, loss, and basis. As Petaluma concedes, however, the Code does not define "item." Moreover, Petaluma's attempt to cabin the meaning of "partnership item" ignores the statute's plain language authorizing the Secretary to promulgate regulations that flesh out the definition of that term. §6231(a)(3). The regulations that fulfill that mandate give examples of partnership items that include "[t]he partnership's method of accounting, taxable year, and inventory method." Treas. Reg. §301.6231(a)(3)-1(b). These examples make clear that the meaning of "partnership item" extends well beyond technical accounting elements.

Furthermore, the regulations state that the definition of partnership item includes "the legal and factual determinations that underlie the determination of the amount, timing, and

characterization of items of income, credit, gain, loss, deduction, etc." Treas. Reg. §301.6231(a)(3)-1(b). The determination that a valid partnership exists is a *sine qua non* for determining the amount and characterization of all other partnership items. For example, determining whether there is a valid partnership necessarily controls whether there can be partnership income, partnership gain, partnership losses, and so forth. This regulation establishes that the validity of a partnership is "more appropriately determined at the partnership level," thereby meeting the second requirement of the partnership item test. Thus the determination that a partnership is a sham and lacks economic substance is a partnership item because it is a legal determination that underlies the amount and characterization of other partnership items. *RJT Investments X*, 491 F.3d at 737-38; *Keener v. United States*, 551 F.3d 1358, 1366 (Fed.Cir.2009) (stating that "the nature of a partnership's transaction-and, specifically, whether a partnership transaction is a 'sham'-is a partnership item").

Logically, it makes perfect sense to determine whether a partnership is a sham at the partnership level. A partnership cannot be a sham with respect to one partner, but valid with respect to another. In addition, this conclusion is unsurprising given that this court has affirmed the Tax Court's determinations that a partnership should be disregarded for tax purposes on several prior occasions. *Andantech L.L.C. v. Comm'r*, 331

F.3d 972, 980 (D.C.Cir.2003); *ASA Investerings P'ship v. Comm'r*, 201 F.3d 505, 506 (D.C.Cir.2000). Based on §6233, its implementing regulations, and the regulations elucidating the meaning of "partnership item," we hold that the determination that Petaluma was a sham, lacked economic substance, and should be disregarded for tax purposes is a partnership item. Given the Tax Court's jurisdiction under §6226(f) to determine all partnership items, we conclude that the Tax Court acted within its jurisdiction when it determined that Petaluma was not a valid partnership and should be disregarded for tax purposes.

**C. Outside Basis**

Petaluma also argues that the Tax Court erred in holding that it had jurisdiction to determine that Petaluma's partners had no outside basis in the disregarded partnership. An "outside basis" is the value assigned to a partner's investment in his or her partnership interest. *See American Boat Co. v. United States*, 583 F.3d 471, 474 n. 1 (7th Cir.2009). Under §6226(f), a court reviewing a petition for readjustment of partnership items only has jurisdiction to determine "partnership items." Under TEFRA, every item that is not a partnership item is considered a "nonpartnership item." §6231(a)(4). Items that are affected by one or more partnership items are "affected items." §6231(a)(5). Petaluma argues that outside basis is an affected item, not a partnership item, and therefore the Tax Court had no right to determine

that its partners' outside bases were zero. We agree.

On appeal the Commissioner concedes that outside basis is not a partnership item in this case. Instead, he asserts that outside basis is an affected item whose elements are mainly or entirely partnership items. He maintains that the Tax Court had jurisdiction to state the "obvious conclusion" that a partner cannot have any basis in a disregarded partnership. The correctness of this conclusion is immaterial, however, for the question is not whether the Tax Court's determination was correct, but whether the Tax Court had jurisdiction to make that determination at all in this partnership-level proceeding.

Here, the partners' outside bases are affected items, not partnership items. Unlike partnership items, affected items are determined not at the partnership level, but at the individual partner level. Once the partnership items have been finalized, the IRS may make a corresponding "computational adjustment" to each partner's tax liability. 26 U.S.C. §6230(c)(1)(A)(ii); §6231(a)(6). When a computational adjustment directly increases a partner's tax liability, the IRS can assess the tax and the partner must bring a refund claim to challenge the computation. §6230(c)(1). When a computational adjustment's effect indirectly increases a partner's tax liability and necessitates partner-level determinations concerning affected items, however, the IRS must

issue a notice of deficiency, and normal deficiency procedures apply. §6230(a)(2)(A)(i); *Desmet v. Comm'r*, 581 F.3d 297, 302 (6th Cir.2009) (describing these two assessment procedures).

Under §6226(f), the Tax Court had jurisdiction to determine partnership items, but it did not have jurisdiction to determine affected items. We have already rejected the Tax Court's conclusion that outside basis was a partnership item in this case, and we likewise reject the Commissioner's contention that outside basis, although it is an affected item, could nonetheless be determined in the partnership-level proceeding. The fact that a determination seems obvious or easy does not expand the court's jurisdiction beyond what the statute provides. In other words, it does not matter how low the fruit hangs when one is forbidden to pick it. We hold that the Tax Court had no jurisdiction to determine that Petaluma's partners had no outside basis in the disregarded partnership. Finally, we note that nothing about the concept of outside basis indicates that it is more appropriately determined at the partnership level. If disregarding a partnership leads ineluctably to the conclusion that its partners have no outside basis, that should be just as obvious in partner-level proceedings as it is in partnership-level proceedings. Moreover, with the invalidity of the partnership conclusively established as a partnership-level determination, there is little danger that outside basis will receive

inconsistent treatment at the individual partner level.

**D. Penalties**

Petaluma also challenges the Tax Court's jurisdiction over accuracy-related penalties. The FPAA determined that "the accuracy-related penalty under Section 6662(a) of the Internal Revenue Code applies to all underpayments of tax attributable to adjustments of partnership items of Petaluma FX Partners, LLC." Petaluma argues that since the Tax Court lacked jurisdiction to determine outside basis, it also lacks jurisdiction to determine that penalties apply with respect to outside basis because those penalties do not relate to an adjustment to a partnership item. We agree. As the Tax Court noted, penalties were formerly determined at the partner level. *Petaluma,* 2008 WL 4682543, at *11; *American Boat Co. v. United States,* 583 F.3d 471, 478 (7th Cir.2009). In the Taxpayer Relief Act of 1997, Pub.L. No. 105-34, §1238, 111 Stat. 788, 1026, Congress amended §6221 and §6226(f) so that penalties relating to adjustments to partnership items would be determined at the partnership level. *American Boat Co.,* 583 F.3d at 478. Section 6221 now states that "the tax treatment of any partnership item (*and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item* ) shall be determined at the partnership level" (emphasis added). Likewise, §6226(f) now provides that a

court reviewing a petition for readjustment has "jurisdiction to determine ... *the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item*" (emphasis added).

The Tax Court held that its determination that Petaluma should be disregarded for tax purposes sufficed to give it jurisdiction over accuracy-related penalties. *Petaluma,* 2008 WL 4682543, at * 12. We disagree. True, the determination that Petaluma should be disregarded for tax purposes is a partnership item, but the outside bases of the partners are affected items to be resolved at the partner level. Neither the Tax Court nor the Commissioner on appeal have forwarded any basis for the jurisdiction of the Tax Court over affected items in this proceeding. As it is not clear from the opinion, the record, or the arguments before this court that the penalties asserted by the Commissioner and ordered by the Tax Court could have been computed without partner-level proceedings to determine the affected-items questions concerning outside bases, we are unable to uphold the court's determination of the penalty issues. While it may be that some penalties could have been assessed without partner-level computations, we cannot affirm a decision that has not yet been made. Therefore, we vacate the opinion of the Tax Court on the penalties imposition and computation. It may be that upon remand, a determination can be made for some

portion of the penalties, but neither party has briefed that question before us.

## III. Conclusion

For the reasons set forth above, the decision of the Tax Court is affirmed in part and reversed in part. We affirm the decision of the court that it had jurisdiction to determine the sham nature of the partnership entity. We reverse the decision of the Tax Court insofar as it asserted jurisdiction over the outside-basis issues. We vacate and remand for further proceedings the Tax Court's decision on the penalties question.

*So ordered.*

**United States Court of Appeals for the Federal Circuit**

2000-5045

WALTER PROCHORENKO and OKSANA PROCHORENKO,

Plaintiffs-Appellants,

v.

UNITED STATES,

Defendant-Appellee.

Appeal from the United States Court of Federal Claims in 98-CV-754T, Judge Nancy B. Firestone.

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DECIDED: March 23, 2001.

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*Dennis N. Brager*, Law Offices of Dennis N. Brager, A.P.C., of Los Angeles, CA, argued for plaintiffs-appellants.

*Teresa E. McLaughlin*, Attorney, Tax Division, Department of Justice, of Washington, DC, argued for defendant-appellee. With her on the brief was *Teresa T. Milton*, Attorney.

Before LOURIE, SCHALL, and BRYSON, Circuit Judges.

**LOURIE**, Circuit Judge.

Walter and Oksana Prochorenko appeal from the decision of the United States Court of Federal Claims granting summary judgment in favor of the government and denying the Prochorenkos' motion for summary judgment on their claim for a refund of federal income taxes paid for the years 1982 through 1985. *Prochorenko v. United States,* 45 Fed. Cl. 494 (2000). Because we conclude that the Prochorenkos are not entitled to reduce their partnership tax liability based on the statutory right to a consistent settlement of "partnership items" under I.R.C. §6224(c)(2), we affirm.

## BACKGROUND

After acquiring a limited partnership interest in Syn Fuel Associates in 1982, the Prochorenkos claimed deductions on their joint federal income tax returns for 1982 through 1985 based on their proportional share of the partnership losses. *Id.* at 495. After conducting an audit, the Internal Revenue Service ("IRS") disallowed the claimed partnership losses and issued a Final Partnership Administrative Adjustment ("FPAA") pursuant to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub.L. No. 97-248, 96 Stat. 324 (1982). *Id.* at 495-96. Subsequently, several partners elected to challenge the FPAA in the United States Tax Court. *Id.* at 496. While the appeal in the Tax Court was still pending, several other partners entered into an agreement with the IRS ("the Craig settlement") under terms that were more favorable to the settling partners than those

in the FPAA. *Id.* Dennis Brager, the attorney who represented the settling partners, also represented other Syn Fuel partners who did not enter into the Craig settlement. *Id.*

On March 31, 1993, the Tax Court upheld the FPAA. *Peat Oil & Gas Assocs. v. Comm'r,* 100 T.C. 271, 1993 WL 95582 (1993). On April 30, 1993, Brager sent a letter to all of the non-settling partners that he represented, including the Prochorenkos, informing them of the Tax Court's decision and advising them to request settlements under terms consistent with the Craig settlement. *Prochorenko,* 45 Fed. Cl. at 496. Under I.R.C. §6224(c)(2), if the IRS enters into a settlement agreement "with respect to partnership items" with any partner, other partners have the right to request terms that are consistent with those contained in the previous settlement agreement. Such requests must be made within 150 days from the day on which notice of the FPAA is mailed to the tax matters partner, or within sixty days from the day on which the prior settlement agreement was entered into. I.R.C. §6224(c)(2); Treas. Reg. §301.6224(c) 3T (2000). In his letter, Brager instructed any clients who were interested in requesting such a settlement to do so by May 10, 1993, which was sixty days after the date that the IRS gave notice of the Craig settlement. *Prochorenko,* 45 Fed. Cl. at 497. The Prochorenkos did not make such a request. *Id.* Instead, the non-settling partners (which by operation of law included the Prochorenkos) appealed to the United

States Court of Appeals for the Second Circuit, which affirmed the Tax Court's decision. *Ferguson v. Comm'r,* 29 F.3d 98 (2d Cir.1994).

After paying the disputed taxes, the Prochorenkos learned that another Syn Fuel partner, Anthony Colitti, and his wife had entered into an agreement with the IRS ("the Colitti settlement") on August 17, 1997, under terms that were similar to those granted in the earlier Craig settlement. *Prochorenko,* 45 Fed. Cl. at 497. On May 4, 1995, the Colittis wrote to the IRS seeking "to formalize the agreement that they believe[d] that they entered into." *Id.* at 498. According to the Colittis, they had signified their acceptance of the IRS's earlier settlement offer in 1993. *Id.* Although the IRS disputed the Colittis' contentions as to whether they had timely requested such a settlement, the IRS eventually agreed to settle with the Colittis "through administrative grace only." *Id.* On October 3, 1997, within sixty days from the date the Colitti settlement was finalized, the Prochorenkos filed a request with the IRS for a settlement agreement with terms consistent with the Colitti settlement, which the IRS denied. *Id.* The Prochorenkos subsequently filed tax refund claims for the years 1982 through 1985, based on their request for a consistent settlement, which the IRS also denied. *Id.*

Thereafter, the Prochorenkos filed this suit in the Court of Federal Claims. *Id.* The government filed a motion for summary judgment, and in the

alternative, moved for dismissal for lack of jurisdiction. The Prochorenkos filed a cross-motion for summary judgment. The court granted summary judgment in favor of the government, concluding that the Prochorenkos had failed to state a claim upon which relief could be granted, and denied the Prochorenkos' corresponding cross-motion. *Id.* at 501. The court concluded that the Prochorenkos were not entitled to a reduction of their partnership tax liability based on the Colitti settlement. *Id.* at 495. The court explained that the Colitti settlement did not trigger the right to a consistent settlement under I.R.C. §6224(c)(2) because it was not a settlement "with respect to partnership items." *Id.* at 501. The Prochorenkos now appeal to this court. We have jurisdiction pursuant to 28 U.S.C .A §1295(a)(3) (West Supp.2000).

## DISCUSSION

We review the Court of Federal Claims' grant of a motion for summary judgment "completely and independently, construing the facts in the light most favorable to the non-moving party." *Am. Airlines, Inc. v. United States*, 204 F.3d 1103, 1108 (Fed.Cir.2000) (quoting *Good v. United States*, 189 F.3d 1355, 1360 (Fed.Cir.1999)). In reviewing a denial of a motion for summary judgment, we give considerable deference to the trial court, and "will not disturb the trial court's denial of summary judgment unless we find that the court has indeed abused its discretion." *SuntTiger, Inc. v.*

*BluBlocker Corp.*, 189 F.3d 1327, 1333 (Fed.Cir.1999). Summary judgment is appropriate only when there are no genuine issues of material fact and the moving party is entitled to judgment as a matter of law. *Id.* When both parties move for summary judgment, the court must evaluate each motion on its own merits, resolving all reasonable inferences against the party whose motion is under consideration. *McKay v. United States,* 199 F.3d 1376, 1380 (Fed.Cir.1999). If there are no material facts in dispute precluding summary judgment, our task is to determine whether the judgment granted is correct as a matter of law. *Bankers Trust N.Y. Corp. v. United States,* 225 F.3d 1368, 1372 (Fed.Cir.2000).

A. *Jurisdiction*

Before we reach the merits of the Prochorenkos' appeal, we must first address the government's contention that the Court of Federal Claims lacked jurisdiction over the Prochorenkos' tax refund claim because the United States has not waived its sovereign immunity with respect to such claims. The Court of Federal Claims declined to decide this issue in light of its conclusion that the Prochorenkos failed to state a claim for which relief could be granted. Establishment of jurisdiction, however, is a prerequisite to a decision on the merits. We will therefore determine first whether the Court of Federal Claims had jurisdiction over the Prochorenkos' claim.

The government contends that the Prochorenkos' suit is barred by I.R.C. §7422(h), which precludes suits "for a refund attributable to partnership items." The government argues that the Prochorenkos' claim does not fall within the scope of I.R.C. §6230(c)(1)(B), which allows a partner to file a refund claim for overpayments "attributable to the application to the partner of a settlement." The government contends that this express exception only applies to a partner who is bound by a settlement that the IRS refuses to honor. The Prochorenkos respond that the Court of Federal Claims had jurisdiction to hear their claim under I.R.C. §6230(c)(3), which permits a partner to bring suit if a refund claim under I.R.C. §6230(c)(1)(B) is not allowed. The Prochorenkos contend that I.R.C. §6230(c)(1)(B) allows a partner to file a refund claim for an overpayment due to the failure of the IRS to make a refund based on the application of a settlement entered into with another partner.

We conclude that the Prochorenkos' claim is not barred by I.R.C. §7422(h) because it is not a claim "for a refund attributable to partnership items." Section 7422(h) provides as follows:

> (h) Special rule for actions with respect to partnership items.--No action may be brought *for a refund attributable to partnership items (as defined in section 6231(a)(3)* ) except as provided in section 6228(b) or section 6230(c).

I.R.C. §7422(h) (emphasis added). Section 6231(a)(3), which is located in the subchapter of the Internal Revenue Code that deals with the tax treatment of partnership items, expressly defines the term "partnership items" as follows:

> (3) Partnership item.--The term "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A *to the extent regulations prescribed by the Secretary provide that,* for purposes of this subtitle, *such item is more appropriately determined at the partnership level than at the partner level.*

I.R.C. §6231(a)(3) (emphasis added).

> Items that are "more appropriately determined at the partnership level than at the partner level and therefore are partnership items" are specifically set forth in the applicable regulation. Treas. Reg. §301.6231(a)(3)- 1(a) (2000). Under this regulation, "partnership items" include items such as the income, gains, losses, deductions, and credits of a partnership, *id.*, but do not include an individual partner's right to request a consistent settlement under I.R.C. §6224(c)(2), *see Monti v. United States,* 223 F.3d 76, 82 (2d Cir.2000). As the Second Circuit explained in *Monti:*

> One partner's right to settlement terms consistent with those granted to another partner is not a partnership item, because the question posed requires consideration of the relationship between one partner's situation and another's and the individual's, rather than the partnership's, communications with the IRS. The facts needed to determine whether consistent terms were offered are facts about the partner, not facts about the partnership.

*Id.* at 82-83. Accordingly, we conclude that a partner's right to a consistent settlement under I.R.C. §6224(c)(2) is not itself a "partnership item."

While it is true that the Prochorenkos were seeking a refund of partnership taxes, their refund was not "attributable to partnership items." Rather, it was based on their claimed right to a consistent settlement under I.R.C. §6224(c)(2). The Prochorenkos claimed that they were entitled to a reduction of their partnership tax liability based on a settlement that the IRS had entered into with another partner. Whether or not the Prochorenkos were entitled to such a reduction is an issue that is entirely dependent on their own unique factual circumstances, and has no effect on and is not affected by the tax liability of any of the other Syn Fuel partners. Accordingly, this is not the type of issue that is "more appropriately determined at the partnership level." Treas. Reg. §301.6231(a)(3)-1(a). Construing the phrase

"attributable to partnership items" so broadly as to cover claims that depend on the unique circumstances of an individual partner, and that only affect that partner, would be contrary to the system of separate treatment of partnership items and nonpartnership items established by Congress in enacting TEFRA. *Monti*, 223 F.3d at 82 (explaining that while, at some level of generality, most refund claims for partnership taxes can be characterized as a refund "attributable to partnership items," to treat claims that are entirely dependent on facts peculiar to an individual partner would blur the distinction between proceedings involving partnership items and those involving nonpartnership items, and would be contrary to the system established by Congress in enacting TEFRA). We therefore conclude that the Prochorenkos' claim is not for a refund "attributable to partnership items," and that the Court of Federal Claims had jurisdiction to hear the Prochorenkos' claim.

B. *The Colitti Settlement*

We next address the parties' arguments concerning whether the Prochorenkos are entitled to a consistent settlement under §6224(c)(2). The Prochorenkos argue that they are entitled to a settlement consistent with the Colitti settlement, which they characterize as a settlement "with respect to partnership items" that reduced the Colittis' tax liability for partnership items. The Prochorenkos contend that the Court of Federal

Claims erred in determining that the Colitti settlement was merely a settlement of the Colittis' claim that they were entitled to a consistent settlement under I.R.C. §6224(c)(2). The Prochorenkos also contend that the IRS had the authority to settle "partnership items" with the Colittis under I.R.C. §§6404(a) and 6224(c)(2), and that even if the IRS did not have such authority, the Colitti settlement still triggered the Prochorenkos' right to request a consistent settlement under I.R.C. §6224(c)(2) because it was voidable and not void *ab initio*.

The government responds that the Prochorenkos are not entitled to a consistent settlement under I.R.C. §6224(c)(2) because the Colitti settlement was not a settlement "with respect to partnership items." The government asserts that the Colitti settlement was instead a settlement of the Colittis' claim that they were entitled to terms consistent with the earlier Craig settlement, based on their timely election in 1993. The government argues that the IRS compromised with the Colittis based on their unique factual claim, and not on a claim that related to the substantive treatment of Syn Fuel partnership items.

We agree with the government that the Prochorenkos are not entitled to a consistent settlement under I.R.C. §6224(c)(2) because the Colitti settlement was not a settlement agreement "with respect to partnership items." We reach this

conclusion based upon the plain language of the relevant statutes. *See Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108, 100 S.Ct. 2051, 64 L.Ed.2d 766 (1980) ("[T]he starting point for interpreting a statute is the language of the statute itself. Absent a clearly expressed legislative intention to the contrary, that language must ordinarily be regarded as conclusive."). Section 6224(c)(2) provides in relevant part as follows:

> (2) Other partners have right to enter into consistent agreements.--If the Secretary enters into a settlement agreement with any partner *with respect to partnership items* for any partnership taxable year, the Secretary shall offer to any other partner who so requests settlement terms for the partnership taxable year which are consistent with those contained in such agreement.

I.R.C. §6224(c)(2) (emphasis added). Thus, according to the plain language of the statute, whether the Prochorenkos are entitled to a consistent settlement under I.R.C. §6224(c)(2) depends on whether the Colitti settlement was a settlement "with respect to partnership items."

The Court of Federal Claims expressly determined that "[t]he undisputed evidence shows that the [Colittis] claimed that they sought a consistent settlement in 1993." *Prochorenko,* 45 Fed. Cl. at 501. The court noted that the Colittis

wrote to the IRS on May 4, 1995, seeking "to formalize the agreement that they believe[d] that they entered into by communicating their desire to accept the settlement offer to the attorney for the partnership." *Id.* at 498. The court further noted that although the IRS disputed the Colittis' contentions, the IRS eventually agreed to settle with the Colittis "on terms similar to the 'Craig settlement.' " *Id.* Thus, the record supports the court's determination that the Colitti settlement was a settlement of the Colittis' factual claim that they were entitled to terms consistent with the Craig settlement, based on their request in 1993, rather than a settlement of partnership items. In other words, the Colitti settlement specifically resolved the issue whether the Colittis had a right to a consistent settlement under I.R.C. §6224(c)(2), based on their unique factual circumstances.

In light of our earlier determination that a partner's right to a consistent settlement under I.R.C. §6224(c)(2) is not a "partnership item," we conclude that the Colitti settlement was not a settlement "with respect to partnership items." While the Colitti settlement effectively reduced the Colittis' tax liability for "partnership items," the Colitti settlement itself was not a settlement "with respect to partnership items" because it arose from a claim that was "entirely dependent on facts peculiar to a single partner." *Monti,* 223 F.3d at 82. Whether the Colittis had made a timely request for a settlement offer with consistent terms is a specific factual question that relates solely to the

Colittis, and does not relate to the substantive treatment of Syn Fuel partnership items. Accordingly, the Colitti settlement was not a settlement "with respect to partnership items" that triggered the rights of other partners to obtain a consistent settlement under I.R.C. §6224(c)(2).

In its decision, the Court of Federal Claims concluded that the Colitti settlement could not have been a settlement of partnership items that triggered the rights of other parties under I.R.C. §6224(c)(2) because the IRS did not have the legal authority to settle partnership items once a final judgment on a contested FPAA has been entered. However, having reached the conclusion that the Colitti settlement was not a settlement "with respect to partnership items" on grounds distinct from those relied on by the Court of Federal Claims, it is unnecessary for this court to reach the parties' arguments concerning that issue.

We note that the very same basis that provides for jurisdiction in this case, *i.e.*, that the Prochorenkos' claimed right to a consistent settlement under I.R.C. §6224(c)(2) is not itself a partnership item, also deprives the Prochorenkos of the right to a settlement consistent with the Colitti settlement, because that settlement was not a settlement "with respect to partnership items." The Prochorenkos could have requested a settlement consistent with the earlier Craig settlement, but they failed to do so within 150 days after notice was given to the tax matters partner,

or within sixty days after the date the settlement was entered into. *See* I.R.C. §6224(c)(2); Treas. Reg. §301.6224(c) 3T. Thus, the Prochorenkos were not entitled to a consistent settlement under I.R.C. §6224(c)(2).

The Prochorenkos contend that the Court of Federal Claims' determination, that the IRS had settled the Colittis' claim that they were entitled to a consistent settlement, is contrary to the record evidence because, *inter alia:* (1) the Colittis never claimed that they submitted a timely request to the IRS; and (2) the Colitti settlement had more favorable terms than the Craig settlement. We disagree. While the Colittis may not have specifically contended that they submitted their request directly to the IRS, it is undisputed that the Colittis did claim that they had timely requested a consistent settlement under I.R.C. §6224(c)(2) by communicating their acceptance of the IRS's settlement offer (*viz.*, the Craig settlement) to the attorney for the partnership. *Prochorenko,* 45 Fed. Cl. at 498. Whether or not the Colittis properly made such a request to the IRS does not alter the fact that they claimed that they were entitled to a consistent settlement, and that the Colitti settlement ultimately resolved that claim.

Likewise, although there may have been slight differences in the terms of the Colitti and Craig settlements, that does not negate the fact that the Colitti settlement originated from the Colittis'

factual claim that they were entitled to a settlement consistent with the Craig settlement. Furthermore, the Prochorenkos do not dispute the government's assertion that the differences between the Colitti settlement and the Craig settlement primarily concerned certain "nonpartnership items" (*i.e.*, penalties and tax-motivated interest), and that the IRS was not required to grant consistent settlement terms with respect to such items. Accordingly, none of the Prochorenkos' factual assertions contradict the Court of Federal Claims' determination that the Colitti settlement was a settlement of the Colittis' claim that they were entitled to a consistent settlement under I.R.C. §6224(c)(2).

We have carefully considered the Prochorenkos' other arguments concerning this issue, but find them lacking in merit.

C. *Discovery*

As a final matter, the Prochorenkos argue that the Court of Federal Claims abused its discretion in denying their request for further discovery. The Prochorenkos contend that they were entitled to discovery of all documents relating to the Colitti settlement, including evidence as to what the IRS staff believed that they were settling, because there was a material question as to the nature of the Colitti settlement. The government responds that the Court of Federal Claims properly exercised its discretion in denying the Prochorenkos' discovery request because further

discovery would not have altered the court's conclusion that the Prochorenkos were not entitled to a consistent settlement.

We agree with the government that the Court of Federal Claims did not abuse its discretion in denying the Prochorenkos' discovery request. First, an abuse of discretion standard is a difficult one to meet on appeal. No abuse has been shown here. Moreover, as explained above, the evidence of record supports the court's determination that the Colitti settlement was a settlement of the Colittis' claim that they were entitled to a consistent settlement under I.R.C. §6224(c)(2). Thus, given that the Colitti settlement was not a settlement of "partnership items," additional discovery would not have altered the court's conclusion that the Prochorenkos had no right to a settlement consistent with the Colitti settlement under I.R.C. §6224(c)(2).

## CONCLUSION

For the above reasons, we conclude that the Prochorenkos are not entitled to reduce their partnership tax liability based on the statutory right to a consistent settlement of "partnership items" under I.R.C. §6224(c)(2). Accordingly, we

*AFFIRM.*

**BRYSON**, *Circuit Judge,* dissenting:

I would not reach the merits of this dispute but would hold that the Court of Federal Claims lacked

jurisdiction to entertain the Prochorenkos' claim. I therefore respectfully dissent on that issue.

The first step in the jurisdictional analysis is 26 U.S.C. §7422(h), which provides that no action may be brought "for a refund attributable to partnership items" except as provided in 26 U.S.C. §§6228(b) or 6230(c). The court holds that the Prochorenkos' claim is not barred by section 7422(h) because their claim is not "for a refund attributable to partnership items," but instead is for treatment consistent with that given to the taxpayers in the Colitti settlement. Although the matter is debatable, I would not characterize the Prochorenkos' claim in that way. To be sure, the Prochorenkos are asking to be treated consistently with the Colittis, but the tax items as to which they are seeking consistent treatment are partnership items. The Prochorenkos' tax liability, and thus their right to a refund if they are entitled to one, relates to the tax treatment of those partnership items. The substance of their claim is therefore "attributable to partnership items" in the ordinary sense of that phrase. The Seventh Circuit agrees with this analysis, *see Kaplan v. United States*, 133 F.3d 469, 473 (7th Cir.1998), although the Second Circuit does not, *see Monti v. United States*, 223 F.3d 76, 82 (2d Cir.2000). Because the Prochorenkos are seeking a refund that stems from the tax treatment of partnership items, I think the Seventh Circuit's interpretation of section 7422(h) in *Kaplan* is correct and the Second Circuit's interpretation in *Monti* is not.

In *Monti*, the court ruled that an action brought by non-settling partners seeking tax treatment consistent with that accorded to other partners did not fall within the bar of section 7422(h). The Second Circuit reasoned that the Montis' action was not "attributable to partnership items" because their asserted right to consistent treatment depended on facts specific to them and their dealings with the IRS rather than on facts general to the partnership. *Monti*, 223 F.3d at 82. That reasoning, however, would seem to apply as well to other actions brought by individual partners, such as actions claiming errors in the computations or application of partnership items to particular partners, *see* 26 U.S.C. §6230(c)(1), or actions seeking a refund when the Secretary decides to treat a particular partner's partnership items as non-partnership items, *see* 26 U.S.C. §6228(b). Yet such actions fall within the scope of section 7422(h) and are exempted from its ban only by express exceptions in section 7422(h). The fact that an action turns on facts specific to particular partners therefore does not keep it from being an action "for a refund attributable to partnership items," within the meaning of section 7422(h), as long as the tax issues on which the refund request is based arise from partnership items.

The Prochorenkos do not dispute that section 7422(h) is applicable to their claim; instead, they contend that the Court of Federal Claims has jurisdiction over their complaint because their claim falls within the express exception to section

7422(h) for claims brought under section 6230(c). That subsection provides in pertinent part that a partner may file a claim for a refund on the ground that "the Secretary failed to allow a credit or to make a refund to the partner in the amount of the overpayment attributable to the application to the partner of a settlement...." The Prochorenkos interpret that language to provide an exception for claims based on the failure to give a partner the benefit of a prior partnership settlement. I disagree. Although the statutory language is not entirely clear on this point, it is most naturally interpreted to refer to claims in which the Secretary fails to make a refund or allow a credit in the proper amount based on a prior settlement that *has been* applied to the partner. The Prochorenkos contend that section 6230(c) also includes a claim for a refund that should have been paid based on a prior partnership settlement that *should have been* applied to the partner filing the claim, but the statutory language is not so broad. It refers to a refund "attributable to the application to the partner of a settlement," not to a refund attributable to the erroneous failure to apply a settlement to the partner. The narrower reading of section 6230(c)(1)(B) is not only more consistent with the statutory language, but it is also more in accordance with the title of the subsection, "Claims arising out of erroneous computations, etc." Consistent with the title, the subsection is most naturally read to apply to errors resulting from mistakes in applying the terms of a prior

settlement to the suing partner, not to the Secretary's refusal to make a prior settlement applicable to the suing partner at all. Because I am persuaded that the bar of section 7422(h) applies to the Prochorenkos' claim and that the exception to that bar in section 6230(c) does not, I would vacate the judgment in this case and remand with directions to dismiss the complaint for lack of jurisdiction.

**United States Court of Appeals for the Federal Circuit**

2009-5010

WILLIAM H. SCHELL and RUBY G. SCHELL,

Plaintiffs-Appellants,

v.

UNITED STATES,

Defendant-Appellee.

Thomas E. Redding, Redding & Associates, P.C., of Houston, Texas, argued for plaintiffs-appellants. With him on the brief were Sallie W. Gladney and Teresa J. Womack.

Bruce R. Ellisen, Attorney, Appellate Section, Tax Division, United States Department of Justice, of Washington, DC, argued for defendant-appellee. With him on the brief were John A. DiCicco, Acting Assistant Attorney General, and Arthur T. Catterall, Attorney.

Appealed from: United States Court of Federal Claims

Judge Susan G. Braden

**United States Court of Appeals for the Federal Circuit**

2009-5010

WILLIAM H. SCHELL and RUBY G. SCHELL,

Plaintiffs-Appellants,

v.

UNITED STATES,

Defendant-Appellee.

Appeal from the United States Court of Federal Claims in 04-CV-1743,

Judge Susan G. Braden.

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DECIDED: December 22, 2009

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Before LOURIE, ARCHER, and GAJARSA, Circuit Judges.

GAJARSA, Circuit Judge.

William H. Schell and Ruby G. Schell (collectively "Taxpayers") appeal from the decision of the Court of Federal Claims ("trial court") dismissing their complaint that alleged the Internal Revenue Service ("IRS") unlawfully denied their claim for a tax refund for the tax years 1993 and 1995. See Schell v. United States, 84 Fed.

Cl. 159 (2008). Because we find that Taxpayers do not have standing to challenge the actions of the IRS, we affirm the trial court's finding that it lacked jurisdiction over the Taxpayers' refund claims.

## BACKGROUND

In the early 1980s, American Agri-Corp, Inc. ("AMCOR") organized a number of limited partnerships and solicited investments from individuals. In the mid-1980s, William H. Schell invested in two limited partnerships offered by AMCOR. Specifically, Mr. Schell held a limited partnership interest in Canyon Desert Vineyards ("CDV") during the tax years 1985-1993 and in Vista Ag-Realty Partners ("VARP") during the tax years 1986-1995. In 1985, CDV reported losses on farming expenses of approximately $7.4 million and $196,000 as "other deductions." Mr. Schell reported his pro rata share of his loss, which totaled $73,811, on his 1985 tax return. In 1986, VARP reported losses on farming expenses of approximately $11.1 million and $291,000 as "other deductions." Mr. Schell reported his pro rata share of his loss, which totaled $69,840, on his 1986 tax return.

After examining the returns of these partnerships, the IRS issued a Notice of Final Partnership Administrative Adjustment ("FPAA") to each partnership, disallowing farming expenses and other deductions. The listed reasons for complete disallowance included the IRS' findings

that "[t]he partnership's activities constitute a series of sham transactions" and "[t]he partnership's activities lack economic substance." Both CDV and VARP filed petitions for readjustment of these findings in the United States Tax Court. CDV and VARP dissolved in 1993 and 1995, respectively.

In April 1997, while CDV and VARP's petitions for readjustment were pending before the Tax Court, the Taxpayers entered into two settlement agreements with the IRS. Under these partner-specific settlement agreements, the $7.6 million net loss reported by CDV in 1985 was reduced by fifty five percent, or approximately $3.4 million. The $11.1 million net loss reported by VARP in 1986 was reduced by fifty percent, or approximately $5.6 million. The settlement agreements made no mention of the "sham transaction" determinations in the FPAAs.

In 1998, the Taxpayers filed an "AMCOR-Related Refund Claim" for the tax year 1995, decreasing their 1995 income from VARP by $9,522. As a result, the IRS refunded $3,930 plus interest. In 1999, the Taxpayers filed a refund claim for the tax year 1993 and a second refund claim for the tax year 1995, claiming that "[a]s a direct consequence of the settlement and the corrections of the erroneous reporting of a termination distribution, there was a substantial basis in the partnership interest and a resulting loss upon the dissolution and termination of the

partnership, which loss is the basis of this claim for refund."

In 2001, the Tax Court issued decisions in the partnership-level proceedings. The decisions found that the adjustments to partnership income and expense were attributable to transactions "which lacked economic substance . . . so as to result in a substantial distortion of [partnership income and/or expense]."

In 2002, the IRS rejected the Taxpayers' second refund claim for the tax year 1995. The IRS also informed the Taxpayers that AMCOR claims are treated as capital losses and it included instructions for claiming these losses. The IRS has not taken any action on the 1993 refund claim.

Instead of resubmitting their claim, the Taxpayers filed a complaint in the trial court, alleging that the IRS unlawfully denied the Taxpayers' claim for a tax refund for the tax years 1993 and 1995. The Taxpayers' theory was that the 1997 settlement agreements increased their basis of the partnership interest by the amount of loss the settlement agreements disallowed. The government filed a motion to dismiss, arguing that the trial court lacked subject matter jurisdiction under I.R.C. §7422(h), or in the alternative, that the Taxpayers failed to state a claim under Court of Federal Claims Rule 12(b)(6). The court granted the government's motion holding that: (1) the losses identified in the Taxpayers' 1999 tax refund claims concern "partnership items," which the

Taxpayers have no standing to pursue under §7422(h); and (2) the exception to §7422(h) under I.R.C. §6230(c)(1)(B) does not apply because the 1997 settlement agreements did not alter the FPAA's findings that the activities of CDV and VAPR were sham transactions and thus did not convert the partnership items into non-partnership items.

The Taxpayers timely appealed to this court. We have jurisdiction to review the final decision of the trial court pursuant to 28 U.S.C. §1295(a)(3).

## DISCUSSION

The Court of Federal Claims' decision to grant the government's motion to dismiss for lack of jurisdiction is a matter of law that we review de novo. Mudge v. United States, 308 F.3d 1220, 1224 (Fed. Cir. 2002). As the party seeking the exercise of jurisdiction, the Taxpayers have the burden of establishing that jurisdiction exists. Rocovich v. United States, 933 F.2d 991, 993 (Fed. Cir. 1991).

### I.

A partnership is not a taxable entity. Partnerships neither incur tax liability, nor do they pay taxes. Before Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), each partner filed his own tax return reflecting his distributive share of the partnership's gains and losses, and IRS audited each individual partner in the partnership. As a consequence, the IRS could not guarantee

consistent treatment of a partnership item for each partner in a partnership. To address this concern, TEFRA was enacted and the treatment of partnership items is now resolved in a unified partnership-level proceeding. See I.R.C. §6221 (2006). Partnerships are required to file informational returns reflecting the distributive shares of income, gains, deductions, and credits attributable to their partners, wh le individual partners are responsible for reporting their pro rata share of tax on their income tax returns. See I.R.C. §701.

TEFRA defines three types of items: "partnership item," "nonpartnership item," and "affected item." "Partnership item" generally encompasses items "required to be taken into account for the partnership's taxable year," and those "more appropriately determined at the partnership level than at the partner level." I.R.C. §6231(a)(3). Such items include the income, gains, losses, deductions, and credits of a partnership. Treas. Reg. §301.6231(a)(3)-1(a) (2009). The term also includes "the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing and characterization of income, credit, gain, loss, deduction, etc." Treas. Reg. §301.6231(a)(3)-1(b). "Nonpartnership items" are those items that are not partnership items, and an "affected item" is defined as "any item to the extent such item is affected by a partnership item." I.R.C. §6231(a)(4)-(5). An example of an "affected item" is

a partner's tax basis in his partnership interest, which is affected by partnership items such as partnership income or loss.

If the IRS decides to adjust any "partnership items" reflected on the partnership's return, it must notify the individual partners of the adjustment through a FPAA. See I.R.C. §6223. For ninety days after a FPAA issues, the tax matters partner has the exclusive right to challenge the proposed adjustments in United States Tax Court, the Court of Federal Claims, or a United States District Court. I.R.C. §6226(a).

At the partner level, a partner may contest the tax liability by paying the assessment and filing a refund action in the Court of Federal Claims. I.R.C. §6226(c). However, TEFRA limits a partner's ability to seek a refund based on adjustments made to the partnership's return by depriving all courts of jurisdiction to hear partner refund claims where the refund is "attributable to partnership items (as defined in section 6231(a)(3)) except as provided in section 6228(b) or section 6230(c)." I.R.C. §7422(h).

Alternatively, a partner may choose to settle his individual tax liability with the IRS. I.R.C. §6224. When a partner chooses to settle his individual tax liability with the IRS, that partner would no longer participate in the partnership level proceeding, and instead would be bound by the terms of his settlement agreement. See I.R.C. §6224. If the IRS enters into a settlement agreement with any

partner with respect to partnership items, other partners are entitled to a consistent settlement as to those partnership items. I.R.C. §6224(c)(2).

II.

The Taxpayers argue that their 1999 refund claims are not barred by §7422(h) because they are not attributable to partnership items; and even if they are, the §6230(c)(1)(B) exception to the §7422(h) jurisdictional bar should apply.

Specifically, the Taxpayers argue that their refund claims are not barred by §7422(h) because they are attributable to the loss of Schell's tax basis in his partnership interests upon termination of the partnerships. The government does not dispute that the Taxpayers' basis in their partnership interest is not a partnership item. Instead, the government argues that the Taxpayers' refund claims are "attributable to partnership items." See I.R.C. §7422(h) (emphasis added). This court has held that the applicability of §7422(h) turns on whether the Taxpayers' refund claims are "due to, caused by, or generated by" a partnership item. Keener v. United States, 551 F.3d 1358, 1365 (Fed. Cir. 2009) (quoting Electrolux Holdings, Inc. v. United States, 491 F.3d 1327, 1331 (Fed. Cir. 2007).

It is widely accepted that a transaction that lacks economic substance is not recognized for federal income tax purposes. See id. at 1365; see also Coltec Indus., Inc. v. United States, 454 F.3d

1340, 1353-54 (Fed. Cir. 2006); Lerman v. Comm'r, 939 F.2d 44, 45 (3d Cir. 1991) (stating that a transaction that "is devoid of economic substance . . . simply is not recognized for federal taxation purposes"); Kirchman v. Comm'r, 862 F.2d 1486, 1490 (11th Cir. 1989); Salley v. Comm'r, 464 F.2d 479, 483 (5th Cir. 1972); Winn-Dixie Stores, Inc. v. Comm'r, 113 T.C. 254, 278 (1999) (stating that "denial of recognition means that such a transaction cannot be the basis for a deductible expense"). Thus, a sham transaction, devoid of economic substance, cannot be the basis for a deductible loss. Therefore, the Taxpayers' refund claims are based on the assertion that the partnerships' transactions were not shams. This court has previously held that the question of whether a partnership transaction is a "sham" is a "partnership item." Keener, 551 F.3d at 1365-66. Accordingly, the Taxpayers' claims are "attributable to" partnership items and the trial court correctly determined that it lacked jurisdiction over the Taxpayers' refund claims.

The Taxpayers also argue that the §6230(c)(1)(B) exception to the §7422(h) jurisdictional bar should apply. Section 6230(c)(1)(B) provides an exception to §7422(h):

> A partner may file a claim for refund on the grounds that . . . the Secretary failed to allow a credit or to make a refund to the partner in the amount of the overpayment attributable to the application to the partner of a

> settlement, a final partnership administrative adjustment, or the decision of a court in an action brought under section 6226 or section 6228(a).

When a partner chooses to settle his individual tax liability with the IRS, the settling individual's partnership items are converted to non-partnership items, but only when the IRS enters into a settlement agreement with the partner with respect to such items. See I.R.C. §6231(b)(1)(C) ("[T]he partnership items of a partner for a partnership taxable year shall become nonpartnership items as of the date . . . the Secretary or the Attorney General (or his delegate) enters into a settlement agreement with the partner with respect to such items . . . .") (emphasis added). Thus, when a partner files an action for a refund attributable to partnership items that have been converted through a settlement agreement, the jurisdictional bar of §7422(h) no longer applies. See id.

The Taxpayers argue that, even if their claims are attributable to partnership items, the IRS "failed to allow credit or make a refund . . . attributable to the application to the partner" of the 1997 settlement agreements. They argue that the 1997 settlement agreements effectively determined that the partnerships' transactions were not shams, and the sham-transaction issue was converted to non-partnership item under §6231(b)(1)(C).

It is undisputed that the 1997 settlement agreements did not explicitly address the sham-transaction issue. The Taxpayers argue, however, that the IRS implicitly conceded that the partnerships' transactions were not shams because: (1) §6224(c) settlements are comprehensive; and (2) the IRS allowed partial deductions, whereas no deduction is allowed for sham transactions. Both of these arguments are without merit. The Taxpayers' argument that all §6224(c) settlements are comprehensive stems from a regulation that reads, "[s]ettlements shall be comprehensive, that is, a settlement may not be limited to elected items." Temporary Regulations, 52 Fed. Reg. 6779, 6787 (Mar. 5, 1987) (issuing Temporary Regulation §301.6224(c)-3T(b)). As the government correctly notes, however, the cited regulation does not require that every §6224(c) settlement be "comprehensive"; rather, it requires that, to obtain a consistent settlement, a partner who enters into a settlement agreement must agree to all the terms that were in the settlement agreement that the IRS previously entered into with other partners. See Keener v. United States, 76 Fed. Cl. 455, 465 (2007), aff'd, 551 F.3d 1358 (Fed. Cir. 2009). In addition, the Taxpayers' argument that the IRS implicitly conceded that the partnerships' transactions were not shams by allowing partial deductions is wholly without merit. The fact that the IRS chose to settle does not follow that it conceded that the transactions were not shams. In addition, that the FPAAs listed

"sham transaction" as one of several grounds for disallowing partnership does not, as the Taxpayers suggest, render the FPAAs less conclusive. Keener, 551 F.3d at 1366.

## CONCLUSION

Because the 1997 settlement agreement did not change the FPAA's findings that the activities of CDV and VARP were sham transactions, the sham-transaction issue was not converted into a non-partnership item, and the Taxpayers' refund claims necessarily involve resolution of "partnership items." Accordingly, the Taxpayers do not have standing to seek adjudication, and the trial court correctly determined that it lacked jurisdiction over the Taxpayers' refund claims.

## AFFIRMED

## COSTS

Costs to the Appellee.

**United States Court of Appeals,**
**Fifth Circuit.**

03-20174

MORRIS A. WEINER,

Plaintiff-Appellant
-Cross-Appellee,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee
-Cross-Appellant,

Consolidated with No. 03-20176

MARION S. KRAEMER; JOYCE W. KRAEMER,

Plaintiffs-Appellants,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

Appeals from the United States District Court
for the Southern District of Texas

Before JOLLY, DAVIS and JONES, Circuit Judges.

EDITH H. JONES, Circuit Judge:

Appealing in two related cases from separate courts, Morris Weiner, Marion Kraemer, and Joyce Kraemer seek refunds of federal income taxes and interest paid in connection with their investments in various partnerships. Three issues are raised. First is the question whether federal courts have jurisdiction, notwithstanding 26 U.S.C. §7422(h), to entertain the taxpayers' complaints that Notices of Final Partnership Administrative Adjustments (FPAAs) were untimely filed and cannot be the basis of assessments against them. Second, the taxpayers challenge substantial interest charged against them for "tax-motivated transactions" pursuant to now-repealed §6621(c). We hold that the courts lacked jurisdiction over the statute of limitations issue and that §6621(c) interest was improperly charged. The third issue was resolved by a recent decision of this court at odds with the trial courts' decisions. *See Beall v. United States*, 336 F.3d 419 (5th Cir.2003) (district courts have jurisdiction to resolve taxpayers' deficiency interest abatement requests under §6404(e)).

*I. The Factual Background*

In the early 1980s, the taxpayers, all high-income professionals, invested in limited partnerships organized by American Agri-Corp ("AMCOR"). Weiner was a limited partner in Travertine Flame Associates ("TFA"); Joyce Kraemer was a limited partner in Oasis Date Associates ("ODA"); and Marion Kraemer was a limited partner in Coachella Fruit Growers

("Coachella"). The partnerships were farming entities that projected tax write-offs of approximately two hundred percent of the amount invested. The taxpayers reported their proportionate share of partnership losses on their 1984, 1985, and 1986 income tax returns.

In 1990 and 1991, the Internal Revenue Service ("IRS") sent each of the partnerships a Notice of FPAA that disallowed farming expenses and other deductions for a number of reasons, including that the partnerships' transactions were "shams" and lacked economic substance. Also in 1991, partners in TFA and ODA commenced a Tax Court action challenging the adjustments as time-barred. Because Weiner and Joyce Kraemer were partners in TFA and ODA, they automatically became parties to the suit. *See* 26 U.S.C. §6226(c).

In early 1997, while the Tax Court cases were still pending, the taxpayers offered to settle their disputed partnership item deductions with the IRS through executions of Forms 870-P(AD). These settlement forms were initially sent to them by the IRS. The settlement agreement purported to disallow sixty-three percent of the deductions, as opposed to a total disallowance. The settlement documents made it clear that the IRS would assess additional tax liability and interest "as provided by law."

After accepting the taxpayers' settlements, the IRS assessed additional tax liability and interest pursuant to §6621(c) in the following manner: for

Weiner in 1984 – in additional tax and $16,663.22 in interest; for the Kraemers in 1984 – $13,159 in additional tax and $16,599 in interest; for the Kraemers in 1986 – no additional tax (because they had overpaid) but $4,088 in interest. The taxpayers commenced their separate refund suits in 2000. They argued in motions for summary judgment: (1) that the statute of limitations prevented the 1984 assessments; (2) that additional interest under §6621(c) was improper as a matter of law; and (3) that the Commissioner had abused his discretion in denying their §6404(e) abatement of interest claim. The *Kraemer* court did not consider the limitations defense because it concluded it lacked subject matter jurisdiction over the issue. The *Weiner* court, however, concluded that it did have jurisdiction, and ultimately decided that the statute of limitations had not run. Both courts also determined that they lacked jurisdiction over the interest abatement claims. Both courts denied the taxpayers' summary judgment motions on the §6621(c) argument and set the issue for bench trials. The Kraemers conceded the issue before trial, but Weiner presented evidence on the merits and the court ultimately concluded that the interest was improper and ruled in Weiner's favor. The instant appeals followed.

*II. The Statutory Background*

This case is governed by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), 26 U.S.C. §§6221-6233, which was enacted to

"improve the auditing and adjustments of income tax items attributable to partnerships." *Alexander v. United States,* 44 F.3d 328, 330 (5th Cir.1995). TEFRA requires partnerships to file informational returns reflecting the distributive shares of income, gains, deductions, and credits attributable to its partners. *Kaplan v. United States,* 133 F.3d 469, 471 (7th Cir.1998). Accordingly, the individual partners are responsible for reporting their pro rata share of tax on their income tax returns. *Id.; see also* 26 U.S.C. §701.

TEFRA requires the treatment of all partnership items to be determined at the partnership level. 26 U.S.C. §6221. While TEFRA defines a "partnership item" in technical terms, the provision generally encompasses items "more appropriately determined at the partnership level than at the partner level." *Id.* §6231(a)(3). All other items are defined as nonpartnership items. *Id.* §6231(a)(4).

If the IRS decides to adjust any "partnership items" reflected on the partnership's return, it must notify the individual partners of the adjustment through a Notice of FPAA. *Kaplan,* 133 F.3d at 471. The IRS is given three years from the later of (1) the date a partnership return is due, or (2) the date the partnership return is filed, to issue an FPAA. 26 U.S.C. §6229(a). The three-year period may be extended by agreement (1) between the Secretary and the partnership's tax matters partner ("TMP") (which binds all partners), or (2)

between the Secretary and an individual partner (which binds only that partner). *Id.* §6229(b)(1). In addition, if the IRS mails an FPAA to the TMP, the three-year period is tolled. *Id.* §6229(d). This three-year limitations period is at issue in this case.

For ninety days following issuance of an FPAA, the TMP has the exclusive right to file a petition for readjustment of the partnership items in Tax Court, the Court of Federal Claims, or a United States District Court. *Id.* §6226(a). After expiration of the ninety-day period, other partners are given sixty days to file a petition for readjustment. *Id.* §6226(b)(1). If a partner's tax liability might be affected by the outcome of the litigation of partnership items, that partner may participate in the proceeding. *Id.* §6224(a), §6224(c). The IRS may assess additional tax liability against individual partners within one year of the final conclusion of the partnership's tax determination. *Id.* §6229(d). The partner may contest the tax liability by paying the assessment and filing a refund action in a United States District Court. However, "[n]o action may be brought [in district court] for a refund attributable to partnership items." *Id.* §7422(h).

But, if a partner settles his partnership tax liability with the IRS, the partner will no longer be able to participate in the partnership level litigation, and will be bound instead by the terms of the settlement agreement. *Id.* §6228(a)(4), §6224(c)(1). In addition, partnership items convert

to nonpartnership items when the IRS enters into a settlement agreement with the partner with respect to such items. *Id.* §6231(b)(1)(C). Thus, if a partner files an action for a refund attributable to partnership items, but those items have been converted through a settlement agreement, the jurisdictional bar of §7422(h) no longer applies. *Alexander v. United States*, 44 F.3d 328, 331 (5th Cir.1995).

*III. FPAA Statute of Limitations*

The *Weiner* and *Kraemer* courts reached opposing conclusions, and the parties disagree on whether district courts have jurisdiction to decide the FPAA statute of limitations question in refund actions.[2] Generally, district courts have jurisdiction over a taxpayer's refund action. 28 U.S.C. §§1340, 1346(a)(1). However, as discussed above, with limited exceptions not applicable here, "[n]o action may be brought for a refund attributable to partnership items (as defined in §6231(a)(3))." 26 U.S.C. §7422(h). The more precise question in this case, then, is whether the taxpayers' refund requests are attributable to any partnership item such that the district court would be deprived of jurisdiction.

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[2] The taxpayers also appeal the *Weiner* court's decision that, because the 1984 partnership returns were invalid, the statute of limitations did not begin to run. We need not reach this argument.

This court reviews a district court's grant of summary judgment de novo and considers the same criteria that the district court relied upon when deciding the motion. *Mongrue v. Monsanto Co.*, 249 F.3d 422, 428 (5th Cir.2001). Summary judgment is only appropriate when "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). In addition, we review a district court's determination of subject matter jurisdiction de novo. *Calhoun County, Tex. v. United States*, 132 F.3d 1100, 1103 (5th Cir.1998).

The taxpayers' refund claims are based entirely on the theory that the IRS had no authority to assess tax against them in 1990 and 1991 because the FPAA statute of limitations had run for the years 1984 to 1986. Accordingly, to avoid the jurisdictional bar of §7422(h), the taxpayers argue that the FPAA statute of limitations, found in

§6229(a), is not a "partnership item."[3] As noted

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[3] Although a partner's settlement agreement with the IRS converts partnership items to nonpartnership items and thereby lifts §7422(h)'s jurisdictional bar, the conversion did not occur in this case. The Code provides that only those partnership items encompassed by the settlement agreement are converted to nonpartnership items. *See* 26 U.S.C. §6231(b)(1)(C) (partnership items of a partner shall convert to nonpartnership items when "the Secretary or the Attorney General (or his delegate) enters into a settlement agreement with the partner *with respect to such items*") (emphasis added). Section 6229(a) was not mentioned in the taxpayers' settlement agreements and thus may not be considered a converted item.

The holding in *Alexander* is not to the contrary. In that case, the taxpayer filed a refund action based on the IRS's admission, in a separate Tax Court proceeding, that the FPAA statute of limitations had run. 44 F.3d at 330. Because it was unnecessary for the court to determine the merits of the statute of limitations question when examining its jurisdiction to hear the refund suit, the court did not examine, as we must in this case, whether the FPAA statute of limitations was a partnership item that deprived the court of jurisdiction. Instead, the court examined the basis for its general grant of jurisdiction over the refund suit. In this regard, the court asked whether "the adjustments called for in the FPAA" were partnership items and determined that the settlement agreement, which settled those items specifically, converted them to nonpartnership items. *Alexander,* 44 F.3d at 331. Thus, the court found that it had jurisdiction to decide the *partner-specific* question of whether the taxpayer's settlement agreement *contractually* barred the refund (an issue not present in this case).

before, TEFRA defines a "partnership item" as

> any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for the purposes of [subtitle F], such item is more appropriately determined at the partnership level than at the partner level.

26 U.S.C. §6231(a)(3). The taxpayers argue that because §6229(a), containing the FPAA statute of limitations provision, is found in subtitle F, as opposed to subtitle A, it is not a partnership item. Furthermore, the taxpayers argue that no treasury regulation specifically refers to the limitations issue as a partnership item. *See* 26 C.F.R. §301.6231(a)(3)- 1(a). The *Weiner* court reasoned that this omission, coupled with the fact that §6229(a) is found only in subtitle F, prevents the FPAA statute of limitations from attaining partnership item status. We disagree with this conclusion.

First, the majority of courts to consider this issue have held that the FPAA statute of limitations issue is a partnership item that must be litigated in a partnership level proceeding. *See Chimblo v. Commissioner*, 177 F.3d 119, 125 (2nd Cir.1999); *Kaplan v. United States*, 133 F.3d 469, 473 (7th Cir.1998); *Williams v. United States*, 165 F.3d 30 (6th Cir.1998) (unpublished table decision); *Barnes v. United States*, No. 95-57-Civ-ORL-22,

1997 WL 732594, *3 (M.D.Fla. July 25, 1997), *aff'd*, 158 F.3d 587 (11th Cir.1998); *Thomas v. United States*, 967 F.Supp. 505, 506 (N.D.Ga.1997); *Slovacek v. United States*, 36 Fed. Cl. 250, 255 (1996). These courts have reasoned that because the FPAA limitations issue affects the partnership as a whole, it should not be litigated in an individual partner proceeding, as such a result would contravene the purposes of TEFRA. *See, e.g., Chimblo*, 177 F.3d at 125. We agree with this reasoning and hold that the district courts lack jurisdiction to consider the taxpayers' statute of limitations argument.

Second, responding to the taxpayers' argument directly, the treasury regulations provide that, for the purposes of subtitle F,

> [t]he term "partnership item" *includes* the accounting practices and the *legal and factual determinations* that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc.

26 C.F.R. §301.6231(a)(3)-1(b) (emphasis added). As the court in *Slovacek* reasoned, the statute of limitations "might be said to affect the amount, timing, and characterization of income, etc., (partnership items) at the partnership level, if only in a thumbs-up or thumbs-down manner." 36 Fed.Cl. at 255. In this way, the treasury regulations have implicitly included the statute of

limitations determination within the definition of "partnership item."[4]

Third, we find distinguishable two cases the taxpayers rely on. In *Monti v. United States*, 223 F.3d 76, 82 (2nd Cir.2000), the court held that a partner's right to seek consistent settlement terms from the IRS was more appropriately considered a nonpartnership item. The Second Circuit relied on several factors to justify this conclusion, among them the fact that the right to consistent settlement terms, located in §6224(c)(2), is found in subtitle F, as opposed to subtitle A. *Id.* at 82. However, the first and arguably most important factor considered by the *Monti* court in deciding how to categorize a partner's right to consistent settlement terms dealt with the practical realities of that right. The court noted that

> [o]ne partner's right to settlement terms consistent with those granted to another partner is not a partnership item, *because* the question posed requires consideration of the relationship between one partner's

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[4] That the FPAA statute of limitations does not appear in subtitle A does not alone defeat this conclusion. The treasury regulations specifically provide that the term "partnership item" *includes* the legal and factual determinations underlying the amount, timing, and characterization of certain partnership items found in subtitle A. Therefore, this definition is broad enough to include in its parameters legal and factual determinations *not* specifically found in subtitle A.

> situation and another's and the individual's, rather than the partnership's, communications with the IRS. The facts needed to determine whether consistent terms were offered are *facts about the partner*, not facts about the partnership.

*Id.* at 82-83 (emphasis added). Conversely, the FPAA statute of limitations determination challenged in this case deals with facts specific to the partnership. The court need not consider the relationship between one partner and another or an individual's communications with the IRS.

Likewise, the court in *Prochorenko v. United States*, 243 F.3d 1359, 1363 (Fed.Cir.2001), relying on *Monti*, concluded that a partner's right to request consistent settlement terms was not a partnership item. That court opined that

> [w]hether or not the [taxpayers] were entitled to such a reduction is an issue that is entirely dependent on their own unique factual circumstances, and has no effect on and is not affected by the tax liability of any of the other [ ] partners. Accordingly, this is not the type of issue that is "more appropriately determined at the partnership level."

*Id.* at 1363 (quoting the treasury regulations) Again, the situation in this case is quite the opposite. The timeliness of an FPAA affects the IRS's ability to make adjustments to partnership

items, which in turn affects all partners alike. This determination is more appropriately made at the partnership level.

From a practical perspective, a finding of jurisdiction over the statute of limitations issue would create an absurd result that contravenes TEFRA. As was the case here, partners could settle with the IRS and thus eliminate their ability to participate in and be bound by the result of any partnership-level proceeding. But if, as here,[5] the Tax Court decided the substantive statute of limitations issue against the partnership, the settling partners could simply bring individual partner-level suits in the district courts and attempt to obtain a different ruling on the statute of limitations issue. Thus, some partners would be required to pay the assessed deficiency, while others would not. The result advocated by the taxpayers here is at odds with TEFRA's goal of consolidating decisions that affect the partnership as a whole.

Finally, the taxpayers contend that this court's decision in *Alexander* controls the determination whether the FPAA statute of limitations is a

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[5] The TMP for TFA and ODA stipulated during the Tax Court litigation that those partnerships' limitations arguments would be governed by the decision in what became known as *Agri-Cal Venture Associates*, 80 T.C.M. (CCH) 295 (2000). TFA and ODA thus became bound by the Tax Court's adverse statute of limitations decision.

partnership or nonpartnership item. In *Alexander*, the taxpayer received an FPAA from the IRS notifying him of an adjustment to partnership items that would affect his tax liability. 44 F.3d at 329. The taxpayer and the IRS eventually entered into a settlement agreement binding the taxpayer to the IRS's treatment of the partnership items. *Id.* at 330. Over a year after making his deficiency payment, however, the taxpayer learned that another partner had challenged the IRS's FPAA adjustments in Tax Court on the basis of the statute of limitations. *Id.* In that proceeding, the IRS conceded that the statute of limitations had expired, and the court entered judgment for the partners. *Id.* Because Alexander had already settled with the IRS, however, the result in the Tax Court did not apply to him. *See* 26 U.S.C. §6231(b)(1)(c). As a result, he filed his own individual refund action in the district court. The Government defended the suit by arguing that the parties' contractual settlement agreement prevented the taxpayer from bringing any suit for refund. 44 F.3d at 330.

A panel of this court addressed its jurisdiction to determine if the settlement agreement barred the refund suit. This court first noted that §7422(h) bars suits for refunds that are "attributable to partnership items." *Id.* at 331. The question then became whether the taxpayer's refund suit was in fact "attributable to" any partnership item. The court noted that while the refund was "at one time attributable to partnership items, that is, to the

adjustments called for in the FPAA," the nature of those items was altered by the settlement. *Id.* Section 6231(b)(1)(C) provides that

> [f]or purposes of this subchapter, the partnership items of a partner ... shall become nonpartnership items as of the date ... the Secretary or the Attorney General (or his delegate) enters into a settlement agreement with the partner with respect to such items[.]

Therefore, the settlement agreement converted the partnership items to nonpartnership items for the purpose of the district court's jurisdiction.[6] The taxpayers argue here that this analysis comports with their jurisdictional argument and thus excepts their case from §7422(h)'s bar.

However, the *Alexander* court did not address the question whether the court had jurisdiction to consider the *substantive* statute of limitations issue. In *Alexander*, as opposed to this case, the Government *conceded* that the statute of limitations barred the assessments. Thus, once the *Alexander* court found that it had jurisdiction generally over the refund suit, the only substantive issue left to be decided was whether the settlement agreement contractually barred the suit. *Id.* at 331-32. The settlement agreement in *Alexander*,

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[6] As discussed *supra* in note 1, conversion does not provide a basis for jurisdiction in this case.

like the one in this case, required the taxpayers to agree that they would not bring any claim for refund based on the changed treatment of the partnership items. *Id.* at 330. The court held that the contractual provision did not bar the refund suit because the taxpayer "[did] not base his refund on the treatment of partnership items at all, but rather on the time-barred deficiency assessed as a result of such treatment." *Id.* at 332. The taxpayers here seize on this language as proof that the statute of limitations question is a nonpartnership issue. However, the *Alexander* court made this statement only in the context of analyzing the *contractual* settlement agreement. The *Alexander* court did not decide whether it had jurisdiction to reach the merits of the statute of limitations argument, because that argument had already been conceded. Thus, *Alexander* does not control the question presented in this case, and this court remains convinced that the district courts lack jurisdiction to decide the FPAA statute of limitations issue. On this issue, the decision of the district court in *Weiner* is therefore incorrect, while the *Kraemer* decision is correct.

*IV. 6621(c) Increased Interest*

Despite its repeal in 1989, the draconian interest provision enacted as §6221(c) continues to dog taxpayers for returns filed during the early 1980s. Consequently, these taxpayers contest the Government's imposition of additional interest

pursuant to 26 U.S.C. §6621(c).[7] The provision imposes an interest rate of 120% of the statutory rate on "any substantial underpayment attributable to tax motivated transactions."[8] 26 U.S.C. §6621(c)(1) (1988). A "substantial underpayment" is any underpayment exceeding $1,000 per tax year. *Id.* §6621(c)(2). Included in the statutory definition of "tax motivated transaction" is "any sham or fraudulent transaction." *Id.* §6621(c)(3)(A)(v).

The taxpayers contend that the trial courts are precluded from upholding the §6621(c) interest assessment because their underlying settlement agreements do not establish that their underpayments were attributable to "tax motivated transactions." In the FPAAs, the Government asserted *several* bases for the disallowance of certain deductions. Among them was a "sham or fraudulent transaction," which qualifies as a "tax motivated transaction" for the purposes of 6621(c). 26 U.S.C. §6621(c)(3)(A)(v). Because the taxpayers settled with the IRS,

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[7] The Kraemers suffered an adverse judgment on this point, while Weiner prevailed on the court's finding that he had a profit motive relevant to the assessment of §6221(c) interest. We do not reach the issue the district court found dispositive. Defending against the Government's appeal, however, Weiner makes, inter alia, the same argument as the Kraemers.

[8] This section was repealed in 1989, but it applies to the tax years in question in this appeal (1984 to 1986).

however, there was never any need for a court to examine the IRS's claimed bases for disallowance and make a determination about their application.

The taxpayers principally rely on *Todd v. Commissioner,* 862 F.2d 540 (5th Cir.1988). *Todd* dealt with the IRS's imposition of the §6659(a) penalty. However, because both sections employ the same "attributable to" language, the analysis in *Todd* is instructive in the §6621(c) context. In *Todd,* this court held that the taxpayers' underpayment was not "attributable to" a valuation overstatement and thus §6659(a)'s penalty did not apply. The taxpayers in *Todd* did not settle with the IRS but instead chose to challenge the IRS's disallowances in the Tax Court. In that proceeding, the Tax Court held that the Todds were not entitled to their deductions and tax credits because the assets had not been put into service during the tax year. *Id.* at 541. On appeal, this court reasoned that because the deductions and credits were disallowed for a reason totally unrelated to any valuation overstatement, the resulting underpayment could not be "attributable to a valuation overstatement." *Id.* at 542.

The court then applied a treasury regulation formula that determines the portion of deductions to which the higher interest rate applies.[9] Because

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[9] The formula for determining the amount of underpayment attributable to a valuation overstatement is as follows:

the court had already determined that no portion of the disallowed deductions and credits were "attributable to" the valuation overstatement, the

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(1) "actual tax liability" (*i.e.*, the tax liability that results from applying all of the IRS's proper adjustments) with

(2) the "actual tax liability" reduced by the valuation overstatement adjustment.

The difference between (1) and (2) is the amount of the underpayment attributable to the valuation overstatement. *See Todd*, 862 F.2d at 542- 43.

Similarly, the amount of *tax motivated underpayment* for §6621(c) is determined in the following manner:

(1) Calculate the amount of the tax liability for the taxable year as if all items of income, gain, loss, deduction, or credit, had been reported properly on the income tax return of the taxpayer ("total tax liability"); and

(2) Without taking into account any adjustments to items of income, gain, loss, deduction, or credit that are attributable to tax motivated transactions ..., calculate the amount of the tax liability for the taxable year as if all other items of income, gain, loss, deduction, or credit had been reported properly on the income tax return of the taxpayer ("tax liability without regard to tax motivated transactions").

The difference between (1) and (2) is the amount of the tax motivated underpayment. *See* 26 C.F.R. §301.6221-2T, A-5.

two sides of the equation were equal.[10] The court noted that "where the deductions and credits ... were inappropriate altogether, the Todds' valuation of the property supposedly generating the tax benefits had no impact whatsoever on the amount of tax actually owed." *Id.* at 543. Or, stated another way, the Todds' underpayment was not "attributable to" a valuation overstatement.

In *McCrary v. Commissioner*, 92 T.C. 827, 1989 WL 35568 (1989), a case also heavily relied on by the taxpayers, the Tax Court adopted the reasoning in *Todd* and concluded that the McCrarys were not subject to §6659(a) or §6621(c) interest on the disallowed investment tax credit. The McCrarys conceded one of the IRS's grounds for disallowing the investment tax credit, thus eliminating the need for a trial on these issues in the Tax Court. *Id.* at 851. The ground conceded by the McCrarys (that their agreement was a license and not a lease) was neither a "valuation overstatement" nor a "tax motivated transaction." The Tax Court noted that alternative grounds could have justified the disallowance, including

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[10] This is because the formula requires the court to determine the portion of underpayment attributable to a valuation overstatement "after taking into account any other *proper* adjustments to tax liability." *Todd*, 862 F.2d at 542 (emphasis added). Therefore, because the Tax Court determined that not placing the assets in service was a "proper adjustment," the two sides of the formula were equal.

sham transaction, which would have qualified for the §6621(c) addition to tax. However, the Tax Court declined to address the sham transaction issue, which was unnecessary to support the conceded disallowance, for the sole purpose of applying §6621(c). *Id.* at 859.

The taxpayers also rely on *Heasley v. Commissioner,* 902 F.2d 380 (5th Cir.1990), in which this court relied on and extended the *Todd* rule. In *Heasley,* the IRS relied on a variety of reasons for disallowing the Heasleys' claimed tax credits. The Heasleys, like the taxpayers here, conceded the deficiency, but continued their suit in the Tax Court to challenge the §6659(a) and §6621(c) additions to tax. The Tax Court concluded that the Heasleys' underpayment was "attributable to" a valuation overstatement under §6659(a). The Fifth Circuit reversed. With regard to §6659(a), this court held that even though the Tax Court specifically found that the underpayment was "attributable to" a valuation overstatement, a situation that differed from that in *Todd,*

> [w]henever the IRS totally disallows a deduction or credit, the IRS may not penalize the taxpayer for a valuation overstatement included in that deduction or credit. In such a case, the underpayment is not attributable to a valuation overstatement. Instead, it is attributable to claiming an improper deduction or credit.

*Heasley,* 902 F.2d at 383.

These cases afford a conceptual lens through which to view the statutory phrase "attributable to" in the context of §6621(c). In *Todd,* the Government argued that "attributable to" really meant "capable of being attributed," such that any time a taxpayer's underpayment was capable of being attributed to a valuation overstatement, the penalty would apply. 862 F.2d at 542. However, the *Todd* court reasoned that the formula indicated that Congress did not intend for the penalty to apply *every* time valuation overstatement was at issue. Likewise, the §6621(c) formula, *supra,* determines the amount of tax motivated underpayment by *first* taking into account any other proper, but *non-tax-motivated,* deductions. On a theoretical level, the formula provides the same reinforcement for viewing "attributable to" *narrowly* in the §6621(c) context.[11] When so

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[11] The Second Circuit rejected this approach and instead adopted the "capable of being attributed" definition in the §6621(c) context. *See Irom v. Commissioner,* 866 F.2d 545, 547 (2nd Cir.1989). In distinguishing *Todd,* the Second Circuit announced a "separability" test: if two grounds for deficiency exist, one of which qualifies as a tax motivated transaction and the other of which does not, and the two grounds are "inseparable," then the formula relied upon in *Todd* does not apply. *Id.* at 547-48. This court in *Heasley,* again relying on *Todd* and the formula, noted *Irom* as contrary authority only. 902 F.2d at 383 n. 5. This represents this circuit's only acknowledgment of the *Irom* rule.

However, even if the *Irom* rule were to apply, the

viewed, it follows that when the FPAA lists several *independent* reasons for disallowing the taxpayers' deductions, there is no way to determine, without additional superfluous litigation, whether the taxpayers' underpayment is "attributable to" a reason that also qualifies as a tax-motivated transaction (such as a sham).

The Tax Court has twice embraced this narrow view of "attributable to" in §6621(c) cases and decided that a taxpayer's blanket concession precludes a finding that any underpayment is "attributable to" a tax motivated transaction. First, in *Rogers v. Commissioner*, 60 T.C.M. (CCH) 1386 (1990), the taxpayers conceded the IRS's ability to disallow deductions. The Tax Court relied on *McCrary, supra,* and reasoned that because "the determination of whether there was a tax-motivated transaction was made only concerning the disputes over the additions to tax and increased interest, we could not conclude that the taxpayer required a trial that otherwise would

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reasons listed by the IRS in the FPAA are "separable." For example, in addition to sham transaction, the FPAA listed as reasons for disallowing the deductions the following, inter alia: (1) the partnership did not actively engage in the trade or business of farming, and (2) the partnership expenses paid or incurred were not ordinary and necessary trade or business expenses deductible under §162. The Tax Court has found that both of these reasons are "separable" from a finding of sham or fraudulent transaction. *Harris v. Commissioner*, 58 T.C.M. (CCH) 1441 (1990).

have been unnecessary." *Id.* at 1397. The taxpayers also cite *Schachter v. Commissioner,* 67 T.C.M. (CCH) 3092, 1994 WL 263329, *5 (1994), in which the court noted that because the taxpayer entered into a stipulation of settled issues and conceded the disallowance of deductions, these actions "obviated the need for a trial on the numerous issues raised in the deficiency notice for the purpose of identifying which, if any of them, provided the substantive ground or grounds for disallowance...." The *Schachter* court was also persuaded that because of the numerous grounds alleged in the notice of deficiency, it was impossible to say that the underpayment was "attributable to" any one ground. The court noted:

> Here, as in [*McCrary*] and [*Rogers*], the melange of alleged grounds, some of which were "tax motivated" grounds – but others were not – prevent us from saying, after the concession, that the underpayment was attributable to a particular ground. We are not inclined, in these circumstances, to rely on petitioners' burden of proof to show that the transaction was not tax motivated, all or in part, for the purpose of section 6621(c). The objectives of administrative efficiency and judicial economy have been well served by the closing agreement and petitioner's concession. Those objectives would not be served by requiring a trial on the substantive issues for the sole purpose of determining whether petitioner is liable for

> 20 percent more interest on the deficiency under section 6621(c).

*Id.* at *6.

The same situation is present in these cases: the taxpayers settled or conceded the disallowances and paid the delinquent taxes, thus removing the need for a trial on the merits of those issues. This court can conceive of no good reason to treat the taxpayers in this case differently from the taxpayers in *Todd, McCrary, Heasley, Rogers*, or *Schachter*. There is no way, given the multiple reasons provided for the disallowance in the FPAAs, to determine whether the underpayments are "attributable to" a tax motivated transaction. Additionally, §6621(c) was one of the provisions enacted by Congress "to deal with the Tax Court backlog." *Todd,* 862 F.2d at 544 n. 14. Yet, fifteen years after the statute's repeal, imposing the penalty in situations such as this does nothing to relieve the Tax Court's backlog, when the taxpayers have in fact settled with the IRS. Because, under the circumstances of these cases, the taxpayers' underpayments are not "attributable to" a tax motivated transaction as a matter of law, the IRS may not assess the additional interest against them. We thus endorse the result in *Weiner,* albeit on different grounds, but reverse that in *Kraemer*.

*Conclusion*

For the foregoing reasons, we conclude that the district courts lack jurisdiction to consider the taxpayers' FPAA statute of limitations arguments. Further, §6621(c) interest cannot be assessed against the taxpayers as a matter of law. Finally, pursuant to *Beall*, the district courts have jurisdiction to consider the taxpayers' §6404(e) interest abatement claims. Accordingly, the judgments of the trial courts are

AFFIRMED IN PART, REVERSED IN PART, AND REMANDED FOR FURTHER PROCEEDINGS.

# IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 08-20708.

JOHN C. DUFFIE; MELISSA DUFFIE

Plaintiffs-Appellants,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee

Appeal from the United States District Court for the Southern District of Texas

ON PETITION FOR REHEARING EN BANC

(Opinion _____, 5 Cir., _____, _____ F.3d _____)

Before Circuit Judges KING, JOLLY, and STEWART,

PER CURIAM:

(X) Treating the Petition for Rehearing En Banc as a Petition for Panel Rehearing, the Petition for Panel Rehearing is DENIED. No member of the panel nor judge in regular active service of the

court having requested that the court be polled on Rehearing En Banc (FED. R. APP. P. and 5th Cir. R. 35), the Petition for Rehearing En Banc is DENIED.

( ) Treating the Petition for Rehearing En Banc as a Petition for Panel Rehearing, the Petition for Panel Rehearing is DENIED. The court having been polled at the reuest of the members of the court and a majority of judges who are in regular active service and not disqualified not having voted in favor (FED. R. APP. P. and 5th Cir. R. 35), the Petition for Rehearing En Banc is DENIED.

ENTERED FOR THE COURT:

/s/ Carl E. Stewart
United States Circuit Judge

*Order on pet EB treat as pan reh-REHG6A*

## INTERNAL REVENUE CODE (26 U.S.C.)

### SEC. 183. ACTIVITIES NOT ENGAGED IN FOR PROFIT

(a) General Rule.—In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

### SEC. 6216. CROSS REFERENCES.

(4) For procedures relating to partnership items, see subchapter C.

### SEC. 6221. TAX TREATMENT DETERMINED AT PARTNERSHIP LEVEL

Except as otherwise provided in this subchapter, the tax treatment of any partnership item shall be determined at the partnership level.

## SEC. 6223. NOTICE TO PARTNERS OF PROCEEDINGS.

(a) SECRETARY MUST GIVE PARTNERS NOTICE OF BEGINNING AND COMPLETION OF ADMINISTRATIVE PROCEEDINGS.—The Secretary shall mail to each partner whose name and address is furnished to the Secretary notice of—

* * * *

(2) the final partnership administrative adjustment resulting from any such proceeding.

* * * *

(d) PERIOD FOR MAILING NOTICE.—

* * * *

(2) NOTICE OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENT.—The Secretary shall mail the notice specified in paragraph (2) of subsection (a) to each partner entitled to such notice not later than the 60th day after the day on which the notice specified in such paragraph (2) was mailed to the tax matters partner.

* * * *

## SEC. 6224. PARTICIPATION IN ADMINISTRATIVE PROCEEDINGS; WAIVERS; AGREEMENTS.

* * * *

(c) SETTLEMENTAGREEMENT.—In the absence of a showing of fraud, malfeasance, or misrepresentation of fact—

(1) BINDS ALL PARTIES .—A settlement agreement between the Secretary and 1 or more partners in a partnership with respect to the determination of partnership items for any partnership taxable year shall (except as otherwise provided in such agreement) be binding on all parties to such agreement with respect to the determination of partnership items for such partnership taxable year. . . .

(2) OTHER PARTNERS HAVE RIGHT TO ENTER INTO CONSISTENT AGREEMENTS .—If the Secretary enters into a settlement agreement with any partner with respect to partnership items for any partnership taxable year, the Secretary shall offer to any other partner who so requests settlement terms for the partnership taxable year which are consistent with those contained in such settlement agreement. . . .

(3) TAX MATTERS PARTNER MAY BIND CERTAIN OTHER PARTNERS.—

(A) IN GENERAL.—A partner who is not a notice partner (and not a member of a notice group described in subsection (b)(2) of section 6223) shall be bound by any settlement agreement—

(i) which is entered into by the tax matters partner, and

(ii) in which the tax matters partner expressly states that such agreement shall bind the other partners.

* * * *

**SEC. 6225. ASSESSMENTS MADE ONLY AFTER PARTNERSHIP LEVEL PROCEEDINGS ARE COMPLETED.**

(a) RESTRICTION ON ASSESSMENT AND COLLECTION.—Except as otherwise provided in this subchapter, no assessment of a deficiency attributable to any partnership item may be made (and no levy or proceeding in any court for the collection of any such deficiency may be made, begun, or prosecuted) before—

(1) the close of the 150th day after the day on which a notice of a final partnership administrative adjustment was mailed to the tax matters partner, and

(2) if a proceeding is begun in the Tax Court under section 6226 during such 150-day period, the decision of the court in such proceeding has become final.

* * * *

**SEC. 6226. JUDICIAL REVIEW OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENTS**

(a) PETITION BY TAX MATTERS PARTNER.—Within 90 days after the day on which a notice of a final partnership administrative adjustment is mailed to the tax matters partner, the tax matters partner may file a petition for a readjustment of the partnership items for such taxable year with—

(1) the Tax Court,

(2) the district court of the United States for the district in which the partnership's principal place of business is located, or

(3) the Claims Court.

(b) PETITION BY PARTNER OTHER THAN TAX MATTERS PARTNER—

(1) IN GENERAL.—If the tax matters partner does not file a readjustment petition under subsection (a) with respect to any final partnership administrative adjustment, any

notice partner (and any 5-percent group) may, within 60 days after the close of the 90-day period set forth in subsection (a), file a petition for a readjustment of the partnership items for the taxable year involved with any of the courts described in subsection (a).

* * * *

(5) TAX MATTERS PARTNER MAY INTERVENE.—The tax matters partner may intervene in any action brought under this section.

* * * *

(c) PARTNERS TREATED AS PARTIES.—If an action is brought under subsection (a) or (b) with respect to a partnership for any partnership taxable year—

(1) each person who was a partner in such partnership at any time during such year shall be treated as a party to such action, and

(2) the court having jurisdiction of such action shall allow each such person to participate in the action.

(d) PARTNER MUST HAVE INTEREST IN OUTCOME.—

(1) IN ORDER TO BE PARTY TO ACTION.—Subsection (c) shall not apply to a partner after the day on which—

(A) the partnership items of such partner for the partnership taxable year became

nonpartnership items by reason of 1 or more of the events described in subsection (b) of section 6231, or

(B) the period within which any tax attributable to such partnership items may be assessed against that partner expired.

(2) TO FILE PETITION.—No partner may file a readjustment petition under subsection (b) unless such partner would (after the application of paragraph (1) of this subsection) be treated as a party to the proceeding.

* * * *

(f) SCOPE OF JUDICIAL REVIEW.—A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates and the proper allocation of such items among the partners.

## SEC. 6228. JUDICIAL REVIEW WHERE ADMINISTRATIVE ADJUSTMENT REQUEST IS NOT ALLOWED IN FULL.

(a) REQUEST ON BEHALF OF PARTNERSHIP.—

* * * *

(4) PARTNERS TREATED AS PARTY TO ACTION.—

* * * *

(B) PARTNERS MUST HAVE INTEREST IN OUTCOME.—For purposes of subparagraph (A), rules similar to the rules of paragraph (1) of section 6226(d) shall apply.

* * * *

## SEC. 6230. ADDITIONAL ADMINISTRATIVE PROVISIONS

(a) COORDINATION WITH DEFICIENCY PROCEEDINGS.—

(1) IN GENERAL.—Except as provided in paragraph (2), subchapter B of this chapter shall not apply to the assessment or collection of any computational adjustment.

(2) DEFICIENCY PROCEEDINGS TO APPLY IN CERTAIN CASES.—

(A) Subchapter B shall apply to any deficiency attributable to—

(i) affected items which require partner level determinations, or

(ii) items which have become nonpartnership items (other than by reason of section 6231(b)(1)(C)) and are described in section 6231(c)(1)(B).

* * * *

(c) CLAIMS ARISING OUT OF ERRONEOUS COMPUTATIONS, ETC.—

(1) IN GENERAL.—A partner may file a claim for refund on the grounds that—

(A) the Secretary erroneously computed any computational adjustment necessary—

(i) to make the partnership items on the partner's return consistent with

the treatment of the partnership items on the partnership return, or

(ii) to apply to the partner a settlement, a final partnership administrative adjustment, or the decision of a court in an action brought under section 6226 or section 6228(a), or

(B) the Secretary failed to allow a credit or to make a refund to the partner in the amount of the overpayment attributable to the application to the partner of a settlement, a final partnership administrative adjustment, or the decision of a court in an action brought under section 6226 or section 6228(a).

(2) TIME FOR FILING CLAIM.—

(A) UNDER PARAGRAPH (1)(A).—Any claim under paragraph (1)(A) shall be filed within 6 months after the day on which the Secretary mails a notice of computational adjustment to the partner.

* * * *

(4) NO REVIEW OF SUBSTANTIVE ISSUES.—For purposes of any claim or suit under this subsection, the treatment of partnership items on the partnership return, under the settlement, under the final partnership administrative adjustment, or under the

decision of the court (whichever is appropriate) shall be conclusive.

* * * *

(d) SPECIAL RULES WITH RESPECT TO CREDITS OR REFUNDS ATTRIBUTABLE TO PARTNERSHIP ITEMS.—

* * * *

(6) Subchapter B of chapter 66 not applicable.—Subchapter B of chapter 66 (relating to limitations on credit or refund) shall not apply to any credit or refund of an overpayment attributable to a partnership item (or an affected item).

* * * *

(l) COURT RULES.—Any action brought under any provision of this subchapter shall be conducted in accordance with such rules of practice and procedure as may be prescribed by the Court in which the action is brought.

## SEC. 6231. DEFINITIONS AND SPECIAL RULES

(a) DEFINITIONS.—For purposes of this subchapter—

* * * *

(3) PARTNERSHIP ITEM.—The term "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

(4) NONPARTNERSHIP ITEM.—The term "nonpartnership item" means an item which is (or is treated as) not a partnership item.

(5) AFFECTED ITEM.—The term "affected item" means any item to the extent such item is affected by a partnership item.

(6) COMPUTATIONAL ADJUSTMENT.—The term "computational adjustment" means the change in the tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item. . . . .

(7) TAX MATTERS PARTNER.—The tax matters partner of any partnership is—

(A) the general partner designated as the tax matters partner as provided in regulations, or

(B) if there is no general partner who has been so designated, the general partner having the largest profits interest in the partnership at the close of the taxable year involved (or, where there is more than 1 such partner, the 1 of such partners whose name would appear first in an alphabetical listing).

If there is no general partner designated under subparagraph (A) and the Secretary determines that it is impracticable to apply subparagraph (B), the partner selected by the Secretary shall be treated as the tax matters partner.

* * * *

## SEC. 6511. LIMITATIONS ON CREDIT OR REFUND

(a) PERIOD OF LIMITATION ON FILING CLAIM .—Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid. Claim for credit or refund of an overpayment of any tax imposed by this title which

is required to be paid by means of a stamp shall be filed by the taxpayer within 3 years from the time the tax was paid.

* * * *

## SEC. 6621. DETERMINATION OF RATE OF INTEREST

* * * *

(c) INTEREST ON SUBSTANTIAL UNDERPAYMENTS ATTRIBUTABLE TO TAX MOTIVATED TRANSACTIONS.—

(1) IN GENERAL.—In the case of interest payable under section 6601 with respect to any substantial underpayment attributable to tax motivated transactions, the rate of interest established under this section shall be 120 percent of the underpayment rate established under this subsection.

(2) SUBSTANTIAL UNDERPAYMENT ATTRIBUTABLE TO TAX MOTIVATED TRANSACTIONS.—For purposes of this subsection, the term "substantial underpayment attributable to tax motivated transactions" means any underpayment of taxes imposed by subtitle A for any taxable year which is attributable to 1 or more tax motivated transactions if the amount of the underpayment for such year so attributable exceeds $1,000.

(3) TAX MOTIVATED TRANSACTIONS.—

(A) In general.—For purposes of this subsection, the term "tax motivated transaction" means—

(i) any valuation overstatement (within the meaning of section 6659(c)),

(ii) any loss disallowed by reason of section 465(a) and any credit disallowed under section 46(a)(8),

(iii) any straddle (as defined in section 1092(c) without regard to subsections (d) and (e) of section 1092),

(iv) any use of an accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period, and

(v) any sham or fraudulent transaction.

* * * *

## SEC. 7422. CIVIL ACTIONS FOR REFUND

(a) No suit prior to filing claim for refund.--No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.

* * * *

(h) Special rule for actions with respect to partnership items.—No action may be brought for a refund attributable to partnership items (as defined in section 6231(a)(3)) except as provided in section 6228(b) or section 6230(c).

## Federal Regulations Effective for the Tax Years in Issue

**Treas. Reg. §301.6221-1T. Tax treatment determined at partnership level (Temporary).—**

(a) *In general.* A partner's treatment of partnership items on the partner's return may not be changed except as provided in sections 6222 through 6231 of the Code and regulations thereunder. Thus, for example, if a partner treats an item on the partner's return consistently with the treatment of the item on the partnership return, the Internal Revenue Service generally cannot adjust the treatment of that item on the partner's return except through a partnership-level proceeding. Similarly, the taxpayer may not put partnership items in issue in a proceeding relating to nonpartnership items. For example, the taxpayer may not offset a potential increase in taxable income based on changes in nonpartnership items by a potential decrease based on partnership items.

* * * *

**Treas. Reg. §301.6621-2T. Questions and answers relating to the increased rate of interest on substantial underpayments attributable to certain tax motivated transactions (temporary).**

The following questions and answers relate to the increased rate of interest on substantial

underpayments attributable to certain tax motivated transactions as provided in section 6621(d) of the Internal Revenue Code of 1954, as added by section 144 of the Tax Reform Act of 1984 (Pub.L. 98-369, 98 Stat. 682):

* * * *

*Q-4. Are any transactions other than those specified in A-2 of this section and those involving the use of accounting methods under circumstances specified in A-3 of this section considered tax motivated transactions under A-2(6) of this section?*

A-4. Yes. Deductions disallowed under the following provisions are considered to be attributable to tax motivated transactions:

(1) Any deduction disallowed for any period under section 183, relating to an activity engaged in by an individual or an S corporation that is not engaged in for profit, and

(2) Any deduction disallowed for any period under section 165(c)(2), relating to any transaction not entered into for profit.

*Q-5. How is the amount of a tax motivated underpayment determined?*

A-5. Except as provided in A-6 of this section, the amount of a tax motivated underpayment is determined in the following manner:

(1) Calculate the amount of the tax liability for the taxable year as if all items of income, gain,

loss, deduction, or credit, had been reported properly on the income tax return of the taxpayer ("total tax liability"); and

(2) Without taking into account any adjustments to items of income, gain, loss, deduction, or credit that are attributable to tax motivated transactions (as defined in A-2 through A-4 of this section), calculate the amount of the tax liability for the taxable year as if all other items of income, gain, loss, deduction, or credit had been reported properly on the income tax return of the taxpayer ("tax liability without regard to tax motivated transactions").

(3) The difference between the total tax liability and the tax liability without regard to tax motivated transactions is the amount of the tax motivated underpayment.

*Example.* Taxpayer A, a calendar year taxpayer, files his 1984 income tax return reporting $70,000 of taxable income and $23,171 of tax liability. On January 20, 1986, A enters into a closing agreement with the Internal Revenue Service that includes the following adjustments:

| | |
|---|---|
| Section 162 deduction disallowed (not tax motivated) | $ 7,500 |
| Loss disallowed under section 465 (tax motivated--see A-2(2) of this section) | $ 5,000 |
| Section 170 deduction disallowed | |

because of a valuation overstatement (tax motivated--see A-2(1) of this section ..... $10,000

Loss disallowed with respect to a straddle as defined in section 1092 (c) (tax motivated--see A-2(4) of this section ..... $ 7,000

Other adjustments (none of which are tax motivated) ..... $ 4,000

The tax motivated underpayment is determined in the following manner:

| | | |
|---|---|---|
| 1. | $ 70,000 | reported taxable income |
| | + 33,500 | (Add all adjustments to items of income, gain, loss, deduction, or credit (including tax motivated transactions subject to section 6621(d))) |
| | $103,500 | Tax = $39,685 ("total tax liability") |
| 2. | $ 70,000 | reported taxable income |
| | + 11,500 | (Add adjustments to items of income, gain, loss, deduction, or credit other than those with respect to items that are tax motivated) |
| | $ 81,500 | tax = $28,691 ("tax liability without regard to tax motivated transactions") |

The tax motivated underpayment ( *i.e.*, the underpayment attributable to tax motivated transactions) is $10,994 ($39,685–$28,691). Accordingly, the interest on $10,994 would be computed at the 120 percent rate.

The remainder of the underpayment (*i.e.*, the underpayment not attributable to tax motivated transactions) is $5,520 ($28,691 (tax liability without regard to tax motivated items)–$23,171 (tax paid with return)). The interest on $5,520 would be computed at the adjusted rate.

## Tax Court Rules

### RULE 245. INTERVENTION AND PARTICIPATION

**(a) Tax Matters Partner:** The tax matters partner may intervene in an action for readjustment of partnership items brought by another partner or partners by filing a notice of election to intervene with the Court. . . . . See Code sec. 6226(b)(2); Rule 241(d)(3).

**(b) Other Partners:** Any other partner who satisfies the requirements of Code §6226(d) or 6228(a)(4)(B) may participate in the action by filing a notice of election to participate with the Court.

. . .

### RULE 247. PARTIES

**(a) In General** : For purposes of this title of these Rules, the Commissioner, the partner who filed the petition, the tax matters partner, and each person who satisfies the requirements of Code §6226(c) and (d) or 6228(a)(4) shall be treated as parties to the action.

**(b) Participating Partners** : Participating partners are the partner who filed the petition and such other partners who have filed either a notice of election to intervene or a notice of election to participate in accordance with the provisions of Rule 245. See Code §§6226(c), 6228(a)(4)(A).

## RULE 248. SETTLEMENT AGREEMENTS

* * * *

**(b) Settlement or Consistent Agreements Entered Into by All Participating Partners or No Objection by Participating Partners:**

(1) After the expiration of the time within which to file a notice of election to intervene or to participate under Rule 245(a) or (b), the Commissioner shall move for entry of decision, and shall submit a proposed form of decision with such motion, if—

* * * *

(B) the tax matters partner (if a participating partner) agrees to the proposed decision in the case but does not certify that no party objects to the granting of the Commissioner's motion for entry of decision.

* * * *

**(c) Other Settlement and Consistent Agreements:** If a settlement agreement or consistent agreement is not within the scope of paragraph (b) of this Rule, then—

(1) in the case of a participating partner, the Commissioner shall promptly file with the Court a notice of settlement agreement or notice of consistent agreement, whichever may be appropriate, that identifies the participating partner or partners who have entered into the

settlement agreement or consistent agreement;

. . . .

TEXAS FARM VENTURERS

EXPLANATION OF ADJUSTMENTS

I.It is determined that the farming expenses claimed on Schedule F in the amount of $9,951,032.00 and the Other Deductions claimed on line 22, page 1 of Form 1065 in the amount of $201,653.00 for the taxable period ending December 31, 1984, are not allowable for the following reasons:

1. The partnership's activities constitute a series of sham transactions.

2. The partnership's activities lack economic substance.

3. The partnership did not engage in the trade or business of farming during the taxable period.

4. The partnership has not substantiated any of the expenses it claimed it paid or incurred during the taxable period.

5. The partnership did not pay or incur any bona fide trade or business expenses during the taxable period.

6. If it is determined that the partnership did pay or incur expenses during the taxable period, it has not been established that the expenses paid or incurred were ordinary and necessary trade or business expenses currently deductible under section 162 of the

Internal Revenue Code and the Regulations thereunder.

In the alternative, if the partnership activities are determined to constitute a valid trade or business, then the following alternate positions are applicable for the taxable periods ending December 31, 1984.

1. The partnership has not substantiated any or all items relating to the following transactions, to the extent that a determination of such items can be made from determinations that the partnership is required to make with respect to an amount, the character of an amount, or the percentage interest of a partner in the partnership, for purposes of the partnership books and records or for purposes of furnishing information to a partner:

    a. Contributions to the partnership; and

    b. Distributions from the partnership.

2. The partnership incurred no bona fide debt and made no bona fide loans with respect to its trade or business of farming.

3. Under section 704 of the Internal Revenue Code and the Regulations thereunder, a partner may not deduct partnership losses exceeding his adjusted basis in the partnership. The partnership has not established that any of its partners signed

any document or assumed the obligation contained in any document which purports to increase some or all of the partners share of the liabilities of the partnership under section 752(a) of the Internal Revenue Code and the Regulations thereunder. For instance, the assumption agreements signed by the limited partners are not includable in their adjusted partnership bases because it has not been established that they represent the assumption of bona fide partnership liabilities as required by the provisions of section 752 of the Internal Revenue Code and the Regulations thereunder. The only matters raised in this subparagraph 3 of this notice of final partnership administrative adjustment which are to be litigated at the partnership level are the components of partners' bases which are partnership items.

4. No distributive shares of any losses from the partnership's activities are allowable because it has not been established that the partners are at risk in any amount for such activities at the close of the taxable period ending December 31, 1984, pursuant to the provisions of section 465 of the Internal Revenue Code and the Regulations thereunder. The only matters raised in this subparagraph 4 of this notice of final partnership administrative adjustment which are to be litigated at the partnership

level are the components of the at risk determination which are partnership items.

5. The expenses claimed for organization of the partnership and syndication fees are not allowable because it has not been substantiated that the partnership has met all of the requirements of section 709 of the Internal Revenue Code and the Regulations thereunder for the deduction of all or part of said claimed expenses.

6. The partnership has not substantiated that it had either investment interest or investment income as those terms are defined in section 163(d) of the Internal Revenue Code and the Regulations thereunder. Therefore, the amount of income claimed on the partnership's return for the taxable period ending December 31, 1984 as investment income are not investment income. The only matters raised in this subparagraph 6 of this notice of final partnership administrative adjustment which are to be litigated at the partnership level are the components of investment interest and investment income which are partnership items.

* * * * * * * * * * *

It is determined that the Tax Preference Item of qualified investment expenses is zero in leiu [*sic*] of the $9,620,476.00 reported on the partnership

tax return for the period ending December 31, 1984, since the expenses on which the tax preference item was based have been adjusted for the reasons stated above. Accordingly, tax preference items have been reduced $9,620,476.00.

* * * * * * * * * * *

It is determined that the Tax Preference Item of qualified investment income is zero in lieu of the $19,611.00 reported on the partnership tax return for the taxable period ending December 31, 1984, because the partnership has not substantiated that it had income that qualifies as investment income.

* * * * * * * * * * *

It is determined that for purposes of section 6229(c) of the Internal Revenue Code, a partner has, with the intent to evade tax, signed or participated directly or indirectly in the preparation of the partnership return which includes a false or fraudulent item for the taxable period ending December 31, 1984.

UNITED STATES TAX COURT

| | | |
|---|---|---|
| TEXAS FARM VENTURERS, ROBERT A. WRIGHT, Tax Matters Partner, | ) | |
| Petitioner, | ) | |
| v. | ) | Docket No. 12539-90 Judge Halpern |
| COMMISSIONER OF INTERNAL REVENUE, | ) | |
| Respondent. | ) | |

**DECISION**

Pursuant to Rule 248(b) of the Tax Court Rules of Practice and Procedure and Respondent's Motion for Entry of Decision, it is

ORDERED AND DECIDED: That the following statement shows the adjustments to the partnership items of Texas Farm Venturers for the taxable years 1984 and 1985, as set forth below:

**1984 Year**

**ADJUSTMENTS TO ORDINARY INCOME:**

| Partnership Item | As Reported | As Determined |
|---|---|---|
| Farming Expense Schedule F | $ 9,515,989.00 | $ 5,361,330.00 |
| Other Deductions | $ 201,653.00 | $ 201,653.00 |

| | | |
|---|---|---|
| Capital Contributed during the year | $ 3,733,500.00 | $ 3,733,500.00 |
| Liabilities | $ 7,612,786.00 | $ 1,809,872.00 |

**TAX PREFERENCE ITEMS:**

| Partnership Item | As Reported | As Determined |
|---|---|---|
| Qualified Investment Income | $ 19,611.00 | $ 19,611.00 |
| Qualified Investment Expense | $ 9,620,476.00 | $ 2,308,914.00 |

**OTHER ADJUSTMENTS:**

| Partnership Item | As Reported | As Determined |
|---|---|---|
| Investment Interest Investment Income | $ 19,611.00 | $ 19,611.00 |

## 1985 Year

**ADJUSTMENTS TO ORDINARY INCOME:**

| Partnership Item | As Reported | As Determined |
|---|---|---|
| Farming Expense Schedule F | $ 3,741,208.00 | $ 3,741,208.00 |
| Costs of Goods Sold Schedule F | $ 9,515,983.00 | $ 9,515,983.00 |
| Other Deductions | $ 293,975.00 | $ 293,975.00 |

**TAX PREFERENCE ITEMS:**

| Partnership Item | As Reported | As Determined |
|---|---|---|
| Qualified Investment Income | $ 4,812,995.00 | $ 4,812,995.00 |
| Qualified Investment Expense | $ 3,994,832.00 | $ 3,994,832.00 |

**OTHER ADJUSTMENTS:**

| Partnership Item | As Reported | As Determined |
|---|---|---|
| Investment Interest Investment Income | $ 150,932.00 | $ 150,932.00 |

That the foregoing adjustments to partnership income and expense for the taxable year 1984 are attributable to transactions which lacked economic substance, as described in former I.R.C. §6621(c)(3)(A)(v), so as to result in a substantial distortion of income and expense, as described in I.R.C. §6621(c)(3)(A)(iv), when computed under the partnership's cash receipts and disbursements method of accounting;

That liabilities in the mount of $5,802,914 lack economic substance; and

That the assessment of any deficiencies in income tax that are attributable to the adjustments to partnership items for the years 1984 and 1985 are not barred by the provisions of I.R.C. §6229.

/s/ James S. Halpern, rz
Judge

Entered: JUL 19 2001